Characteristics and Implications of Different Types of Currency Areas

Miguel Mancera

First let me say that Mexico's possible participation in one or more free trade zones does not imply that we anticipate the formation of monetary unions in these zones. Furthermore, currency areas are not necessarily essential to a free trade zone's good performance, nor are the benefits from the formation of such areas self-evident. It must also be pointed out that formal monetary unions, that is, currency areas established by international treaties, are so complex that for now it would be virtually impossible to establish them in the free trade zones in which Mexico will probably participate.

It is not my intention to propose the adoption of any specific monetary scheme for trade zones. Rather, I would like to offer some reflections on the characteristics and effects of various types of currency areas.

The concept of a currency area can be understood in several ways. The broadest concept is that of a group of two or more countries whose currencies' exchange rates follow predetermined patterns. These patterns result from the exchange rate policies of the countries which are part of the currency area, although the exchange rate policy of the country whose currency serves as reference for the others may be entirely independent.

This type of currency area does not require an international treaty. It can simply stem from the desire and the ability of a country to unilaterally peg its currency's exchange rate (or the rate of change of the same) to another country's currency.

The other extreme might be represented by a currency area formed by a group of countries which adopt a common currency. However, even in this case, there are at least two variants: The United States and Panama, for example, use the same currency, but this is a decision made by Panama alone; in contrast, several European countries are considering the adoption of a common currency to be issued by a community central bank.

Between these extremes, there are several types of currency areas. Some do not require international treaties, tantamount to law, but may nonetheless involve monetary cooperation agreements. Other currency areas, such as the so-called monetary unions, are usually based on international treaties, the scope of which varies from case to case.

Now I would like to review the characteristicsand the implications of various types of currency areas. First, I will discuss the most informal types, and last, I will make a few comments about those with a common currency.

Again, the broadest notion of a currency area is that attained by a country unilaterally pegging its currency's exchange rate to a foreign reference currency (or by fixing the speed of the crawl thereof). This policy can have considerable advantages for the country that fixes its exchange rate, but only if certain conditions are met. The first and by far the most important prerequisite is that the reference currency's purchasing power be reasonably stable. Other conditions are: that prices as well as nominal and real personal income be generally flexible; that the country whose currency is used as a reference be an important trade partner, or that the country that has pegged its currency's exchange rate conduct most of its international trade in the reference currency; that there are no serious obstacles for the international mobility of merchandise; that the country which has fixed its exchange rate is not overly exposed to large external shocks; and, crucially, that sustaining the exchange rate is a real and credible possibility. If this last condition is not met, there will eventually be speculative attacks against the currency, which may lead to an abrupt devaluation. In this case, the public may expect further devaluations, and such expectations imply among other effects, high interest rates, which dampen economic growth.

If all of these conditions are met, especially that of the reference currency's reasonably stable purchasing power, and that of the peg's sustainability, it is very likely that fixing the parity will yield considerable benefits. The country's inflation rate should converge with that of the reference currency, at least in the realm of internationally tradable goods. At the same time, the risk involved in international transactions would be reduced. This implies greater certainty and confidence, which are essential for economic development.

The danger of pegging the exchange rate stems from the risk that these preconditions may not be satisfied due to circumstances beyond the control of the country which fixed the rate. For example, if the exchange rate remains fixed and the country experiences an external shock or the reference currency becomes unstable, the country may face undesirable consequences. In fact, if the country which has a pegged exchange rate undergoes a severe external shock, it could suffer a deep recession, or if the reference currency country has an outbreak of inflation, this would imply general price hikes in the former.

Thus, we might question whether exchange rate rigidity is better than flexibility. Of course, I cannot do justice to such a broad topic within the scope of this discussion; I will, however, offer a few comments.

First, a flexible exchange rate regime does not offer the same results in the case of revaluations as in the case of devaluations. When a currency is revalued to isolate the country from imported inflation, this would not normally have negative effects. Should there be negative effects, they would be minimal compared to the benefits of preserving domestic price stability.

On the other hand, currency devaluations tend to cause inflation and, therefore, ongoing uncertainty, which is very costly in terms of economic development and social equity. However, it is rightly argued that in certain situations, devaluations may in fact be a lesser evil. For example, consider a country where the income of the general population is flexible in real terms, but downwardly rigid in nominal terms. Suppose it has pegged its exchange rate, and then it suffers a massive external shock. In this case, a devaluation and the ensuing higher prices permit the external shock's absorption through a reduction in the real income of a large part of the population, rather than through bankruptcies and public sector program cutbacks, both of which result in unemployment and lower production.

Thus, the most justifiable devaluations are in response to an external shock in the context of downwardly rigid nominal incomes. However, given that devaluations have inflationary consequences, one must ask whether there are not other means of handling the problems caused by, say, a sudden deterioration of the terms of trade or a natural disaster. In this sense, it might be convenient, for example, to remove nominal income rigidities.

An adverse shock inevitably has negative effects; yet a response conducive to inflation creates obstacles to economic growth and causes a chaotic redistribution of real income, which are both much worse than an explicit reduction in nominal income. It is regrettable that when economic reality dictates real income adjustments, these cannot always take place in an orderly and, indeed, civilized fashion. Sometimes the misguided step is taken, although surely with the best of intentions, of making reductions in workers' wages illegal, except in extreme circumstances which may be invoked only with great difficulty. And other times, noninflationary adjustment is problematic since people are misguided by money illusion—they are more willing to tolerate price increases than explicit reductions in their incomes. Such legal provisions, as well as money illusion, cause an unfortunate inflationary bias, the degree of which varies among national economies, but is present in all.

As I mentioned, one of the conditions for successfully pegging an exchange rate is that such action be viable and credible. With this in mind, we might consider establishing legal limits to primary credit expansion. At one extreme, the central bank's statutes may only allow currency to be issued against the purchase of a specific foreign currency or international assets in general. Under a fixed exchange rate regime, such a rule is highly appropriate since it makes it almost impossible for the domestic currency's value to erode with respect to the reference currency. The rule is equivalent, in a certain sense, to adopting the reference currency as the domestic currency, but with the advantage that the reference currency need not circulate within the national territory and, importantly, "seigniorage" can be earned from the issuing of domestic currency. Indeed, the central bank may invest the foreign exchange it purchases overseas, while not paying interest on the domestic currency it issues, and perhaps not paying interest, or only at a reduced rate, on its other monetary liabilities such as the commercial banks' deposits.

A few countries, such as Hong Kong and Singapore, have successfully adopted schemes of this sort. However, in spite of the evident advantages for fixed exchange rate regimes, this is unusual for several reasons: First, it is clear that even under a fixed exchange rate regime, the judicious use of primary credit can, in some measure, influence the evolution of monetary aggregates and interest rates, without jeopardizing exchange rate stability; second, it is obvious that the central bank's function as lender of last resort is nullified or severely limited if it cannot grant credit; under this scheme, the central bank could lend only as long as it had more foreign assets than liabilities. Third, although this is not always acknowledged, with this sort of scheme the government renounces a source of financing which can be very expedient. Of course, expediency as the only motive is questionable, as it has been precisely central banks' abuse of their power to grant primary credit which in many countries and on too many occasions has caused persistent inflation and recurring devaluations. Some countries have therefore relinquished the benefits of a moderate use of primary credit in exchange for the advantages of the monetary stability that results from an absolute confidence in the exchange rate.

Currency unions established by international treaties could be divided into three basic categories: The first is characterized by fixed exchange rates (or exchange rates which fluctuate within a band), but which are revisable and supported by a system of reciprocal credit. The European Monetary System's exchange rate mechanism is an example of this type of currency union. The second type of currency union is the same as the first, but the exchange rates are permanently fixed. The third type of currency union establishes a common central bank and a single currency.

The first type of currency union resembles Bretton Woods, which, you will recall, established an international monetary system characterized by pegged exchange rates. This type of currency union diminishes the member countries' monetary sovereignty in the sense that exchange rate variations cannot be determined unilaterally but must be agreed upon by the union. In exchange for this restriction, an important benefit is obtained: member countries agree to combine credit resources to finance temporary, nonfundamental balance of payments disequilibria and, therefore, support their exchange rates. This is further backed by member countries' efforts to coordinate their fiscal and monetary policies.

The second type of currency union, in which exchange rates are permanently fixed, implies very strict policy coordination among the member countries. In reality, this kind of coordination is closer to that required for the third type of currency union, with a common central bank and a single currency, than it is to the first type. In fact, permanently fixing exchange rates is in almost every sense tantamount to monetary unification. It could also be said that the requirements for policy coordination are virtually the same. However, under permanently fixed exchange rates, since the various domestic currencies would continue in circulation, with some transactions costs in exchanging one currency for another, there would be smaller benefits vis-a-vis a single currency system; this is also true to the extent that the population perceives some possibility, however small, that exchange rates could be modified by "force majeure."

Permanently fixing exchange rates requires that the national monetary authorities cede their prerogative to decide the amount and timing of currency issues to a common monetary authority. The implications of this are profound. National governments give up to an untested agency their de jure or de facto privilege to manage or at least influence their central bank's primary credit. Furthermore, the recognition of a common monetary authority raises questions that are difficult to answer: whether this authority should be independent of the national governments; to whom should it be accountable; how should voting power be allocated among the different countries within the common agency; and who should be responsible for the regulation and supervision of financial intermediaries.

The third type of currency union, in which member countries adopt a single currency, implies the creation of a common central bank. By adopting an organizational framework similar to that of the Federal Reserve System of the United States, a common central bank could take advantage of the various original member country central banks' human and operational resources without incurring the costs of a full-scale merger. This third type of currency union confronts the same problems as the second type of union, as well as some others: for example, how to allocate among the member countries the seigniorage derived from issuing the single currency. On the other hand, the benefits of this third type of union can be impressive. Benefits include the reduction of investment risks, the practical unification of leading interest rates, and considerable savings in the costs of international transactions within the union, all of which are highly favorable for economic development.

Belonging to a currency area has advantages and disadvantages which depend both on the type of currency area being addressed and the circumstances of each country. When it becomes necessary to make a decision concerning this subject, as with many others, it is advisable to adopt an eclectic rather than a dogmatic position. Moreover, considering the enormous variations in the rates of inflation within and among most countries, as well as price and wage rigidities, it is not unreasonable to argue in favor of floating exchange rates, notwithstanding the marked trend toward free trade and currency areas.