CHAZEN INSTITUTE RESEARCH BRIEF

The Optimal State of Monetary Unions

KEY TAKEAWAYS

- ✓ The cost of abandoning currency sovereignty may outweigh the trade benefits of a single currency.
- ✓ Debt defaults are a side effect of monetary unions that eliminate the option to monetize debt in times of financial crisis.
- ✓ The optimal state of a monetary union is one that includes fiscal transfers between member countries and a central bank with the power to monetize debt in times of exigency.

There are multiple benefits for countries operating in a system that has a single currency and a unified monetary policy: elimination of currency risk and reduced transaction costs, to name a few. But as Greece, Portugal, Italy, and Ireland have discovered over the last decade, being a member of a monetary union like the European Union often comes with a costly trade-off.

In "Money, Sovereignty, and Optimal Currency Areas," **Patrick Bolton, Chazen Senior Scholar at Columbia Business School**, and Haizhou Huang, Managing Director and Head of Equities Department of China International Capital Corporation (CICC), examine the costs of joining a monetary union and propose a pathway forward that would help member countries like those in the European Union avoid debt defaults.

Research

Bolton and Huang explore the history of optimal currency areas (OCAs), or geographic regions where a single currency has the potential to create the largest economic impact, from the adoption of the gold standard to its collapse, the birth and death of the Bretton Woods system, and the ongoing debates on how to reform the European Union – and reveal a system that has essentially exacerbated debt crises.

The researchers come to this revelation by revisiting the theory of OCAs, proposed by Robert Mundell in the 1960s, which focuses on the trade benefits of a single currency and provides the intellectual foundation behind the formation of the European Union and creation of the European Central Bank (ECB). Using the Eurozone debt crisis as a prime example, they point out a gap in Mundell's theory: a side effect of monetary unions that eliminate the option to monetize debt in times of crisis.

Building upon previous work in "The Capital Structure of Nations," Bolton and Huang extend their single open-economy model to include multiple countries. Through this exercise, they are able to show that while a monetary union eliminates excess monetization cost, it also removes a nation's monetary sovereignty. This loss of monetary sovereignty, or control over the money supply, the researchers argue, concretely manifests itself through a sovereign debt crisis when a member country faces economic hardship.

Results

The research reveals that fiscal transfers can improve a monetary union by allowing a member country in a poor economic state to avoid a costly default by relying on the fiscal transfers of another member country in a better economic state to service part of the debt it is otherwise not able to service. Further, the scholars suggest that the best arrangement is a monetary union that not only includes fiscal transfers, but also the option for the single central bank to monetize debt to avoid a costly default where multiple member countries are in crisis.

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