

# Solidarity vs. Similarity Criteria: The Political Economy of Currency Unions

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September 3, 2018

## Outline

1. Main Questions
2. Solidarity vs. Similarity Criteria
3. Historical Case Studies (Euro, CFA, EACB)
4. Implications

## Main Questions

- Why do some currency unions succeed while others fail?
- Why do governments continue to express interest in joining currency unions?
- What should African and European policymakers consider in forming, expanding or reforming currency unions?

## Criteria for Success

1. Common Prosperity (economic growth and convergence)
2. Longevity

## Similarity Criteria

- Which areas have the least to lose from relinquishing monetary policy autonomy?
- Optimum Currency Areas (OCA) face synchronous, symmetrical shocks therefore a common monetary policy makes sense

## Neoliberal Adjustment Mechanisms

- OCA exhibit high degree of factor movement, especially labor mobility, to smooth adjustment
- Internal devaluation through flexible labor markets and rules on fiscal spending
- Wages and prices will eventually adjust to achieve external balance between members

## Divergence

- The mainstream implicitly assumes international convergence despite historical evidence to the contrary
- Heterodox growth model incorporate increasing returns to scale, leading to multiple equilibria growth paths (growth miracles and collapses)
- Equilibria selection is a function of political and social institutions and interventions

## Unequal Exchange

- Classic development economics and Marxist dependency theories raise the possibility of unequal exchange between regions/countries, structurally divided into core and periphery.
- If income elasticity of demand for exports and/or bargaining power of labor is asymmetrical between regions, productivity gains in periphery may be captured by capitalists and consumers in core.

## Increasing Returns to Scale

- Generalized IRS both help explain divergence between members and provide a justification for the formation and expansion of currency unions.
- Monetary systems have significant network externalities—a form of increasing returns to scale.
- Similarity criteria may be met ex-post.

## Solidarity Criteria

- Surplus regions recycle surpluses through fiscal system to deficit regions.
- The rich subsidize the poor, with the understanding that the roles may one day reverse.

## Political Surplus Recycling Mechanism

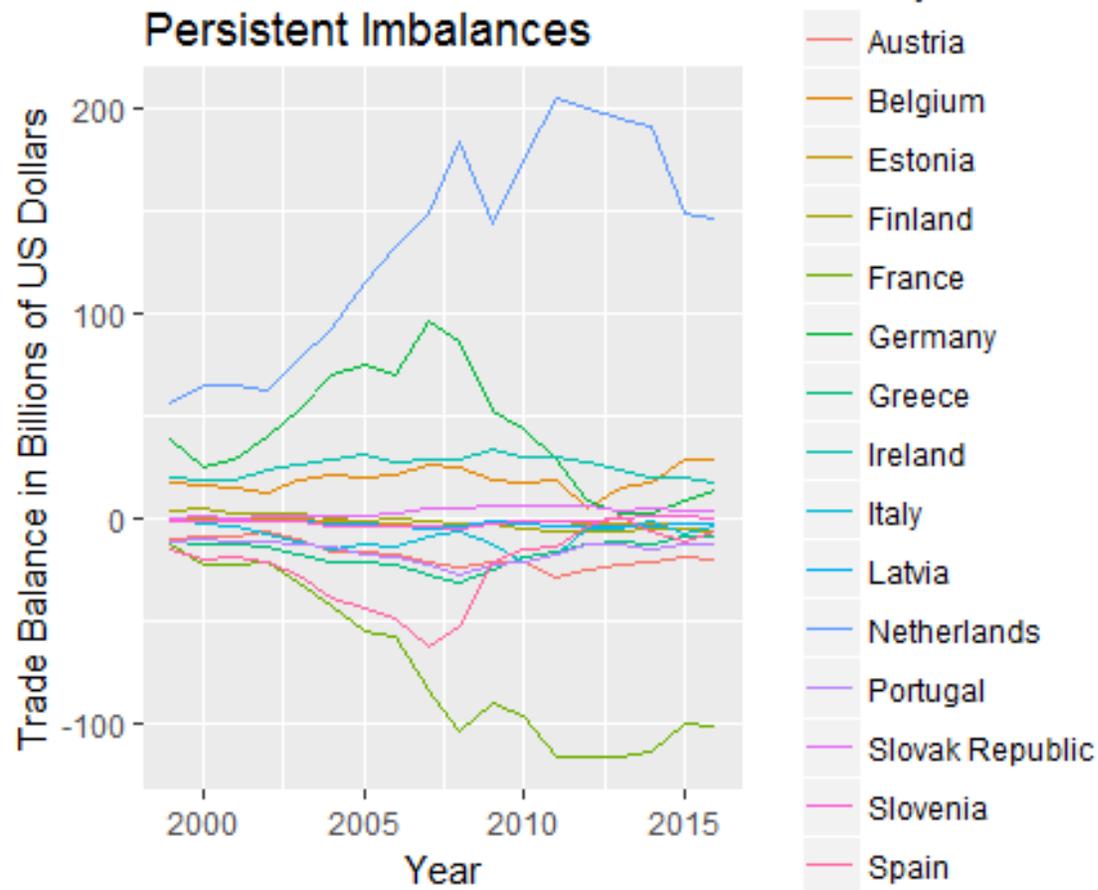
- Given persistent payments imbalances between regions, the most successful monetary unions are also fiscal unions.
- Political integration is “first best” solution.
- Hegemonic power willing to play lender/buyer last resort role is second best.
- Therefore currency union success depends on an effective “political surplus recycling mechanism.”

## Informal Model

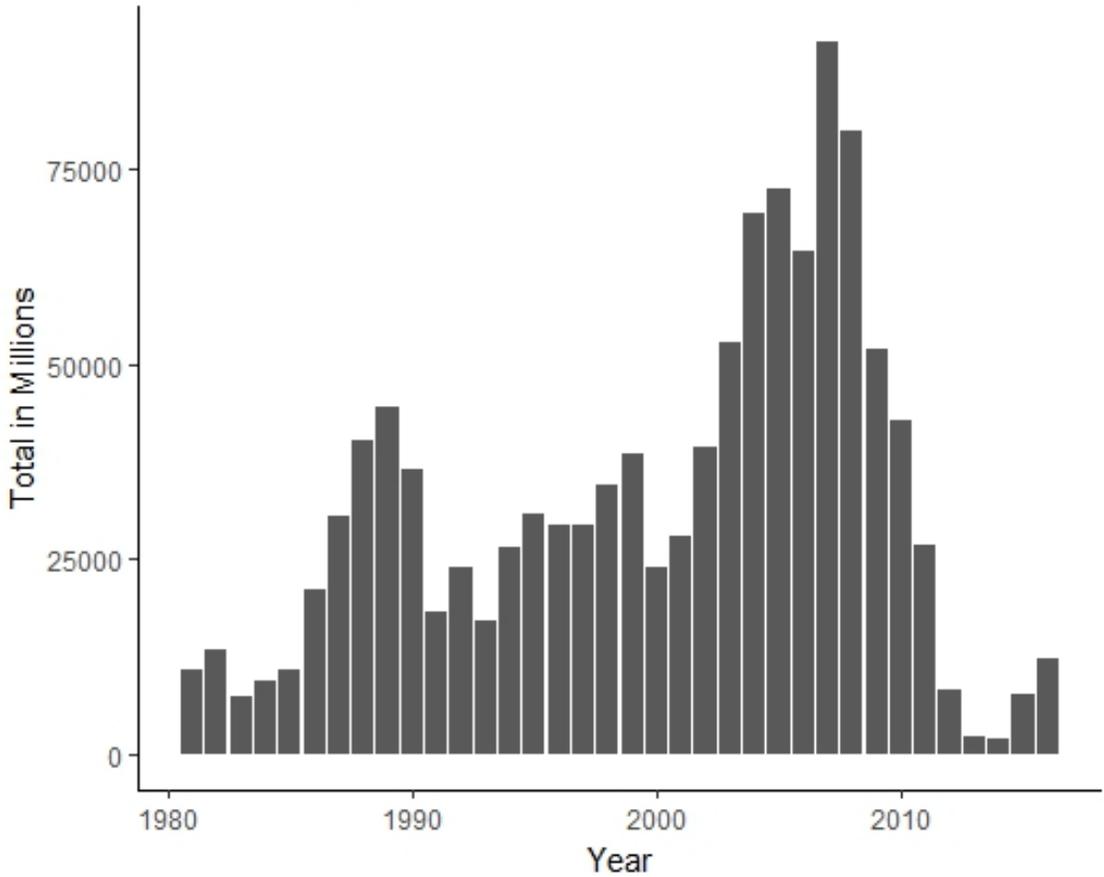
- Economic/Monetary Integration + Progressive Fiscal Redistribution = Convergence + Longevity
- Economic/Monetary Integration - Redistribution Mechanism = Divergence + Political Instability
- Capitalist development inherent uneven geographically. To smooth it out requires political intervention.

## Historical Case Studies

- Germany has refused to play hegemonic role in the eurozone.
- French government played the hegemonic role in the CFA zone ensuring its survival.
- British and Kenyan governments refused to do the same for East African Currency Board therefore it collapsed.



German Trade Surplus with Eurozone 1980-2016

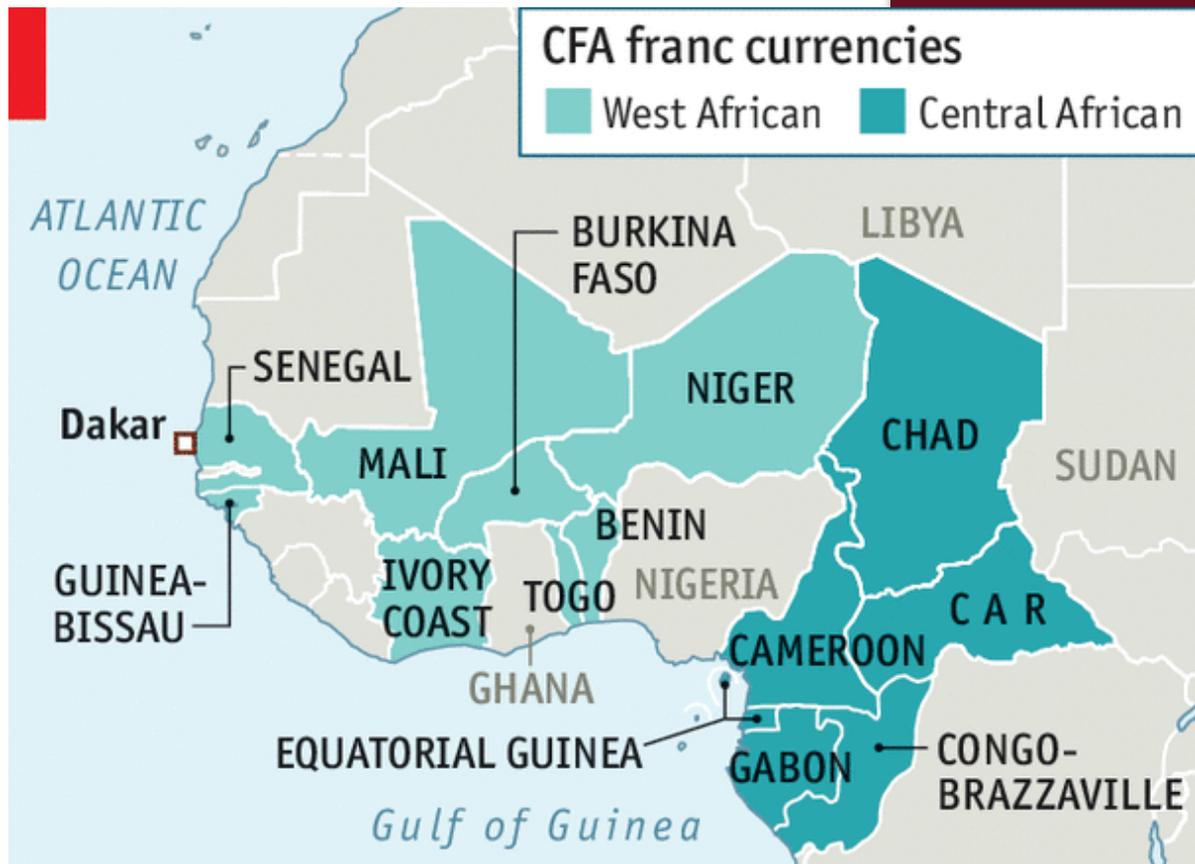


## Germany as Bad Hegemon

- Private capital flows from core to peripheral regions tends to be procyclical
- Convergence criteria (limits on fiscal spending) led ironically to divergence
- Merkel government is opposed to Eurozone as a “transfer union”
- Germany has placed the burden of adjustment on Greece and other peripheral countries to disastrous effect

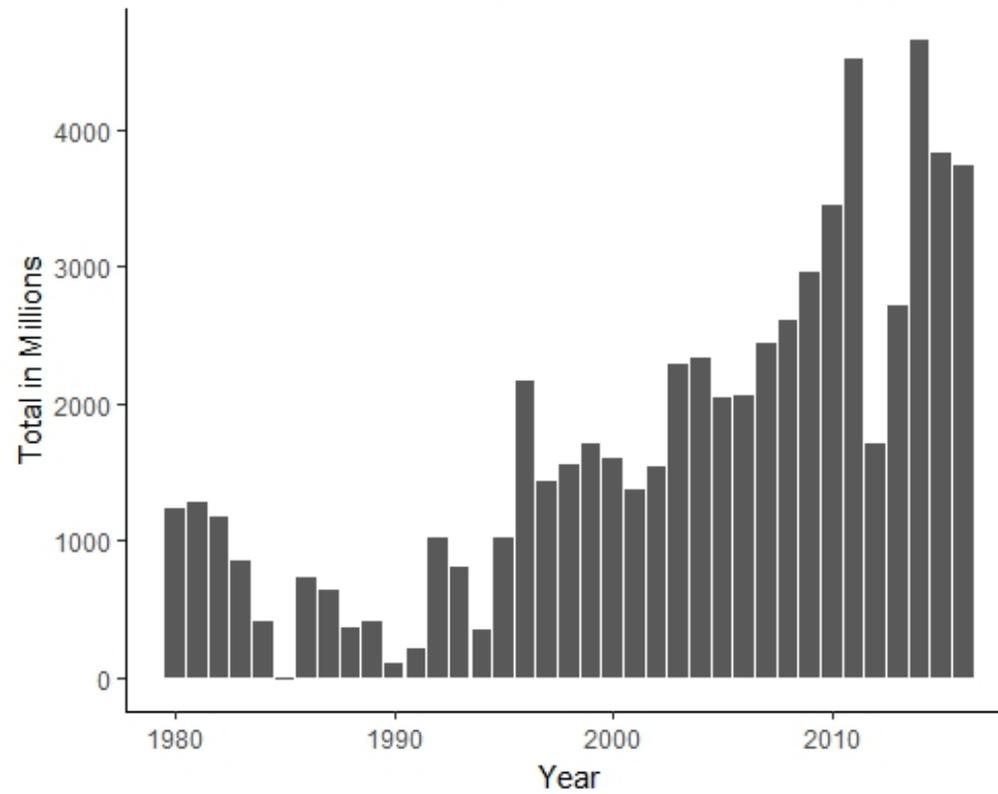
## The Solidarity Option

- The German government could promote expansionary fiscal and wage policies to increase inflation and consumption vis-à-vis the peripheral countries and eliminate its surpluses with them.
- It could write-off Greek debt and allow the Greek government to pursue similar expansionary fiscal policy to end the depression of the Greek economy.
- It could seek more formal political integration.
- Instead, the EU budget is miniscule, about 1 percent of EU GDP.



Economist.com

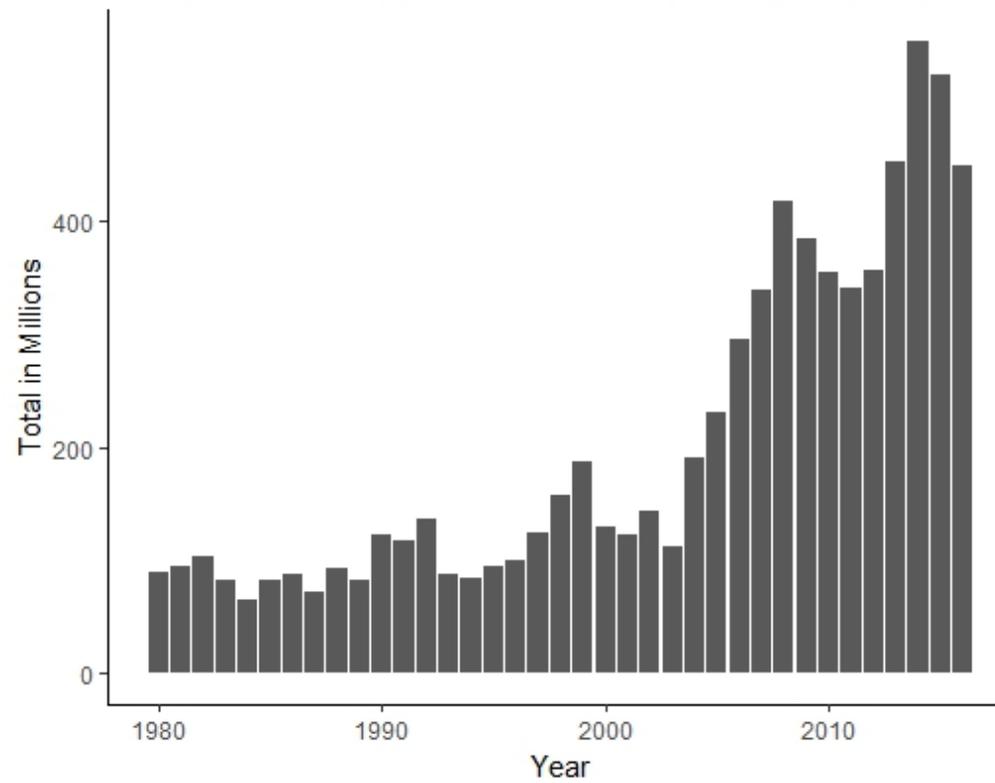
French Trade Surplus with CFA Zone 1980-2016



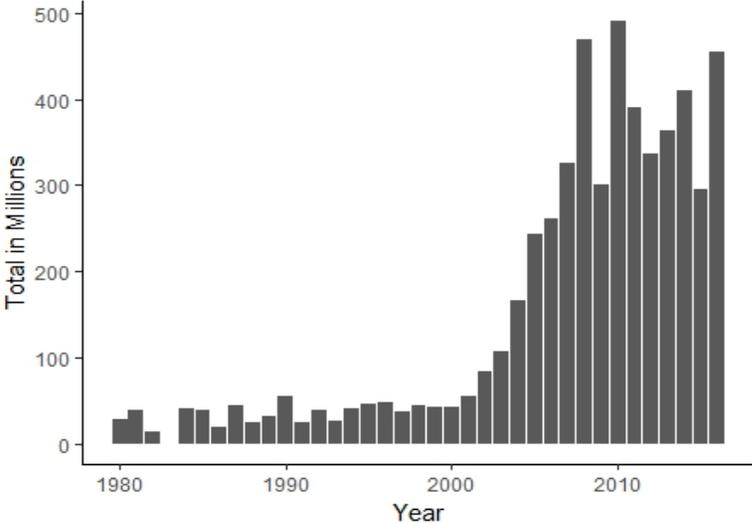
## France as Good Hegemon

- France a “good” hegemon for CFA franc zone, has provided direct and indirect fiscal transfers (via foreign aid and operations account)
- Costs to French government of maintaining CFA zone are modest.

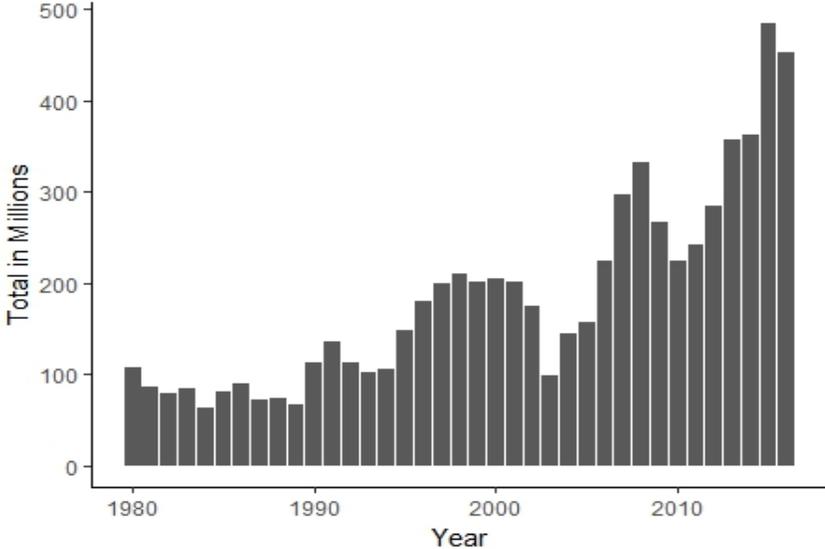
Ivorian Trade Surplus with Burkina Faso 1980-2016



Senegal Trade Surplus with Mali 1980-2016



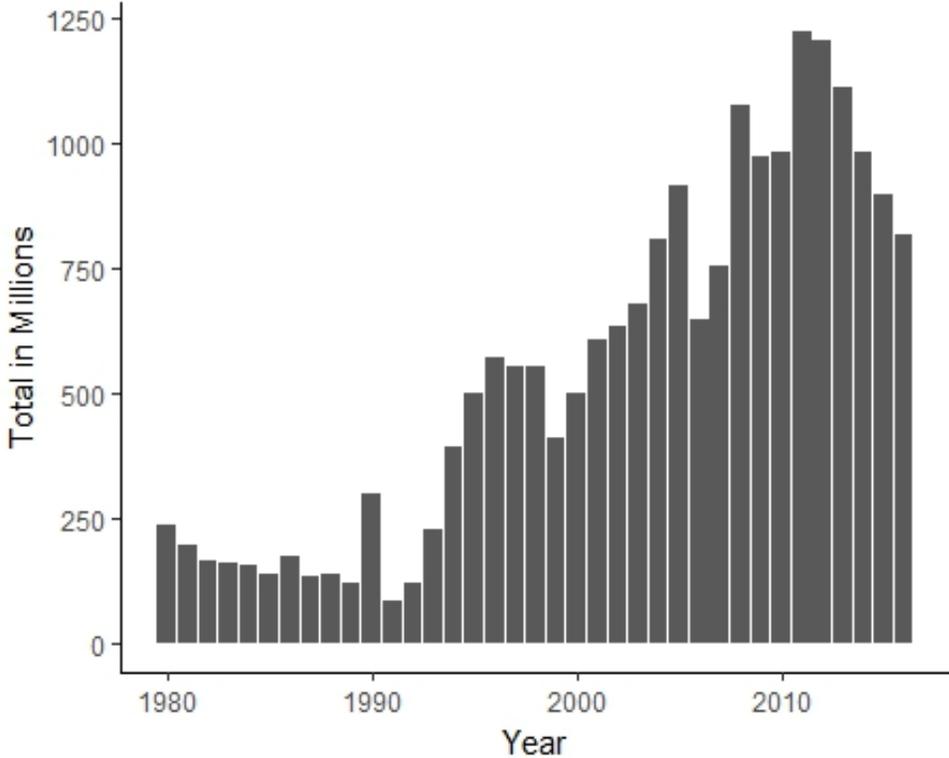
Ivorian Trade Surplus with Mali 1980-2016



## East African Currency Board

- French offered overdraft facility as inducement to former colonies to keep French franc.
- British did not, therefore East African Currency Board collapsed in 1966.
- Kenya did not want to subsidize Uganda and Tanzania.

Kenyan Trade Surplus with EAC 1980-2016



## Implications

- Solidarity is essential, similarity is secondary
- Eurozone should move towards fiscal union if it wants to survive and thrive
- Proposed East African shilling depends on success of East African Federation
- CFA zone will survive as long as French support continues
- Economic integration should not outpace political integration