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Monetary union: European lessons, Latin American prospects

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Abstract

This paper analyzes the long-run sustainability of monetary unions. We infer from the EMU experience that for monetary union to be sustainable, fiscal policy rules are necessary. That does not imply a formal Stability Pact, however. Labor market flexibility is more important for sustainability than cross-border labor mobility. Sound financial markets are another precondition. Lessons for Latin America and the Caribbean include, first, that the benefit-cost balance of a shift to monetary union is much less favorable in Latin America and the Caribbean than in Europe and, most important, that the region is some distance away from satisfying the necessary conditions for monetary union. That leaves dollarization as a limited option for small countries and floating rates combined with inflation targeting for much of the rest.

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1. Introduction

The world is in a state of flux regarding the choice of monetary and exchange-rate regimes. One option is giving up national currencies to join a monetary union. Since Mundell (1961), the literature has emphasized conventional optimum currency area (OCA) criteria in shaping this decision. European Monetary Union (EMU), the largest historical experiment in giving up sovereignty in monetary (and other) policy areas, has captured the imagination of policy makers and researchers alike. It has also brought other issues related to complementary areas

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of reform and integration to the forefront of theory and policy analysis. These issues shape the discussion about monetary union and, more generally, about optimal regime choice for countries in other regions, including Latin America and the Caribbean (LAC).

The purpose of this paper is to assess the long-run sustainability of monetary unions, in the light of theory and of the experience of EMU, and to draw lessons for regime choice, and monetary union in particular, for LAC. In Section 2, we briefly review recent global trends in exchange-rate regimes and discuss the benefits and costs of EMU. This leads to three issues crucial to the long-run sustainability of monetary union, namely, fiscal policy, labor market rigidities, and financial market integration (Section 3). These considerations provide insights in Section 4 into the forces that shape monetary and regime choice in LAC and Section 5 concludes.

2. Monetary and exchange-rate regimes: optimality considerations and real-world constraints

2.1. Global trends in monetary and exchange-rate regimes

Both industrial and developing countries are revising their monetary (M) and exchange rate (ER) regimes. Many countries and regions have shifted regimes—either gradually by careful design (as in EMU) or quickly in reaction to market forces (as in Ecuador in 2000 or Argentina in 2002).

The evolution of official ER regimes is illustrated in Fig. 1. The share of fixed ER regimes—comprising systems with no independent currency, currency boards, and pegged ERs—has declined from 68% of countries in 1979 to 48% in 2001, while managed and independent floats have increased from 17 to 44%. Intermediate regimes, where ERs are adjusted by indicators (sliding pegs, bands, and sliding bands), have fallen from 15% of countries in 1979 to 8% in 2001. As a long-term trend, a shift to ER floats is evident.[1] More recent IMF data based on a finer regime disaggregation confirm the ongoing trend consistent with the two-corner hypothesis (Fig. 1).[2] Between 1999 and 2001, ERs adjusted by indicators have fallen from 12 to 8%, countries without independent currencies have increased from 20 to 22%, managed floats have risen from 14 to 23%, while independent floats have declined from 25 to 21%.[3]

The recent evolution in M regimes is reflected in a survey conducted among 93 central banks in 1998 by Mahadeva and Sterne (1998) and in the larger IMF data base of annual country-based official regime definitions, available since 1999 (Fig. 2). The evidence shows a relatively uniform distribution of M regimes (ER, monetary aggregate, and inflation targets) in the Mahadeva and Sterne data for 1998. The IMF data show a dominance of ER targets, but one which weakens between 1999 and 2001. This is consistent with the growing trend away from monetary and ER anchors and toward inflation targets.

ER and M regimes are certainly not independent of each other and hence it is revealing to look at their joint distribution.[4] As of December 2001, the combined global distribution of ER and M regimes (IMF classification) shows an obvious concentration of regime combinations on the diagonal of Table 1.[5] It is noteworthy that today the world's most popular regime combinations are the currency board or a pegged ER with an ER target (48 countries), followed