Monetary Integration

The questions

- How will EMU affect the *volatility* of economic activity and prices (inflation, the nominal USFD/EUR exchange rate,..) in the EU ?
- How will EMU affect the *volatility* of Swiss economic activity and prices (inflation, the nominal exchange rate,..) as well as the *transmission* of external shocks to Switzerland under a **flexible** and a **fixed** EUR/CHF regime?
- Is the targeting of the EUR/CHF rate equivalent to adopting the EURO from the point of view of Swiss macroeconomic stability?
- What does the targeting of the EUR/CHF rate imply for the properties of monetary policy in Switzerland.

The exchange rate regime and optimum currency area (OCA)

An OCA is a region for which it is optimal to have a single monetary policy

- Mostly symmetric shocks
  - Similarity in production structure
  - Intra-industry trade within the group
  - High degree of commodity diversification

- Easy adjustment to asymmetric shocks
  - High labor mobility. A substitute for exchange rate flexibility
  - High degree of real wage flexibility
  - Fiscal integration
- Exchange rate (monetary) policy is not very effective
  - The openness and size of an economy: Implications for competitiveness and price stability

The EU countries do not seem to satisfy the OCA criteria. The degree of labor mobility, wage/price flexibility, fiscal integration and commodity diversification are low in Europe.

Are Switzerland and the EU an OCA?

- Switzerland is a small, open economy. Limited ability to use the exchange rate instrument to manipulate its international competitiveness
- Its major trading partners are EU members (Germany, France and Italy). Intra-industry trade?
- A common stochastic structure? Optimal monetary policy is different across countries (the same seems to be true for France and Germany)

This can be the source of major conflicts in the conduct of the monetary policy by the ECB

- Low labor mobility
- Significant wage rigidities

A new argument

The endogeneity of the OCA criteria

Not relevant

Other costs and benefits

Elimination of exchange rate uncertainty (effects on trade and investment)

Elimination of the transactions and information costs of exchanging currencies

Policy credibility

Additional issues

The SF as a reserve currency

Seignorage vs monetary control (price stability)

Conclusion

The casual application of the traditional OCA criteria does not produce a clear winner as far as the optimal international monetary arrangement for CH is concerned

Key question

Is the difference between a flexible and fixed EUR/CHF so economically substantial as to not be easily overridden by other selection criteria (such as political considerations)

One needs to not only rank alternative exchange rate regimes but, more importantly, to offer some quantitative measure of the significance of their differences

Main empirical findings

- Under a flexible EUR/CHF rate regime the formation of a currency union in the EU has a destabilizing effect on Swiss output volatility but a negligible effect on inflation volatility.

  The volatility of the EUR/CHF rate also increases significantly relative to that of the DM/CHF rate

- If Switzerland were to rigidly target the EUR/SF exchange rate then this would result in even larger increase in volatility in output(relative to a flexible EURO/SF rate). In this case, inflation volatility would also increase. Output and inflation volatility are now higher relative to a flexible EUR/CHF

This is due to the fact that a pegged EUR/CHF rate contributes a procyclical bias to the conduct of SNB policy (see class note 6 on the amplification of volatility under fixed rates for supply shocks).

It could erode public support for SNB price stability objectives

- The differences between a perfectly credible, rigid fixed EUR/CHF regime and Switzerland's adoption of the EURO are small

- The international transmission of disturbances (impact effect) from the EU to Switzerland is quite small under EMU as long as Switzerland does not adopt the EURO as its currency. If she did, then transmission would become significantly negative.

  The weak or even negative synchronization of economic activity between Switzerland and the EU in a CH-EU currency union (due to the presence of significant country specific supply shocks) could be a potential source of frictions in ECB policymaking.

Possible limitations of the analysis

Non-fundamental fluctuations in the exchange rates

Speculative attacks

Conclusions

- EMU has a destabilizing effect on the Swiss economy

- the choice of the exchange rate policy makes an important difference for Swiss macroeconomic performance
- the targeting of the EUR/CHF rate does not have good properties. A unilateral peg leads to higher macroeconomic instability (real economic activity and inflation) relative to a free float. It could also undermine public support for the SNB's mission of price stability because it contributes a procyclical bias to the conduct of monetary policy

Main factors behind these findings:

i. Country specific influences (and in particular supply shocks) are the most important source of macroeconomic volatility

ii. There exist important differences in the degree of labor market (wage) flexibility across countries. Switzerland is more flexible than its European partners

iii. Switzerland, France and Germany are not an OCA