Tying another's hand: an incentive to join a monetary union

Cem Gorgun
Kocfinans, Turkey
cgorgun@kocfinans.com.tr

Abstract

This paper investigates the monetary regime choice between a monetary union and a flexible exchange rate regime in a large open economy framework. The Mundellian Criterion suggests that a monetary union should be established between countries with positively correlated shocks. This study finds that the Mundellian Criterion is insufficient to determine optimal monetary unions. A country has a significant incentive to choose a monetary union over a flexible exchange rate regime if member countries have larger or proportional cost-push shocks relative to domestic ones. In reverse, a country has a significant incentive to choose a flexible exchange rate regime if domestic cost-push shocks are relatively larger. For this reason, the relative variance of cost-push shocks between countries should be accounted for in the monetary regime choice. A better criterion to identify optimal monetary unions is that countries with positively correlated shocks and proportional cost-push shocks should form monetary unions.

Keywords: monetary union, flexible exchange rate, monetary policy, national welfare, cost-push shocks

JEL Codes: E52, E58, F33, F41, F42