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The influence of the institutional context on the process of monetary integration

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Abstract. The analysis in this paper is based on the theoretical aspects that underlie the theory of optimum currency areas, the main criteria required for a monetary union, with an emphasis on the Euro zone, as well as the need for a stable monetary and financial environment. In the first part of the paper we aim analyzing the concepts, assumptions and theoretical aspects of the topic proposed to research. In the second part of the paper, we examine both the benefits as well the costs involved by the creation of an optimum currency area. In the last part, we focus on analyzing the main conditions for a stable monetary and financial system.
The methodology shows the interdisciplinary character of research corresponding to modern trends in economic theory. The research methodology involves critical analysis, a method aimed at analyzing the arguments of the specialists in the field.
In this context there will be presented in a non-exhaustive manner the main criteria that must be fulfilled by the member states in order to form a monetary union, also will be enumerated the main conditions that need to be obeyed so we will not repeat the same mistakes from the past.

Keywords: monetary process, optimum currency area, monetary stability

1. Introduction

Economic monetary integration is a topical issue, especially for the countries that have already joined the Euro area, as well as for the developing countries which still have to meet a series of criteria in order to be accepted. Although there is a very extensive literature on optimum currency areas, most articles and books in the field focus on how a country can ensure internal stability using the policies that have remained available after the loss of monetary autonomy and exchange rate policy.

The theory of optimum currency aims at identifying the benefits and costs and the timely period for joining a monetary union.

Significant contributions to such a pathway have their origins in earlier works such as that of Nobel economics laureate Robert Mundell, who published an article in the American Economic Review in which he analyzed, from a totally different perspective than its predecessors, the exchange regimes. The conclusion of the article was that "if the world could be divided into regions within which factors are mobile and between which factors are immobile, then each of these regions should have a separate currency fluctuating against all the other currencies" [1]. The author had sensed the challenges faced by the countries wishing to form a monetary union. By analyzing the costs and benefits resulting from adopting a single currency, his work has served as a basis for further analyses.

A few years later, under the influence of Mundell, McKinnon, another theoretician of the optimum currency areas theory, provides a first clear and explicit definition of the optimal currency area: "a currency area in which a single currency and a flexible exchange rate provide the best solution to achieve three major objectives: full employment, balance of payments equilibrium and domestic price stability" [2]. If Mundell believes that an optimum currency area is a set of regions within which the tendency of migration is high enough to ensure full employment when one of the regions is hit by a shock, McKinnon adds economic openness to the above mentioned properties, and, several years later, Peter Kenen (1969) considers that production diversification is a prerequisite of the optimum currency area.

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Therefore, the process of monetary integration and the theory of optimum areas have been the concern of many researchers. From the multitude of definitions generally accepted by those who have spent time and energy on such a topic, we shall mention that of Pelkmans, according to which integration is “a process of gradually eliminating any kind of borders between two or more independent states, which is meant to allow these countries to operate as an entity” and the optimum currency area is “the area for which the cost of giving up flexible exchange rates or the option of realignment is lower than the benefits of a single currency” [3].

It is currently considered that a group of countries can form an optimum currency area if “the disequilibrium affecting the bilateral balances of payments of any two countries within the group can be corrected without modifying the exchange rate between their currencies” [4]. Thus, an area grouping several countries can be considered an optimum currency area if within it the adjustment in case of asymmetric shocks is best achieved by fixed rates, while in the relations with other areas optimal adjustment requires flexible exchange rates.

2. The main optimality criteria

Among the most analyzed issues relating to monetary areas are the criteria to be met by a monetary area in order to be considered an optimal currency area. Further on, we shall try to present in a non-exhaustive manner the main criteria that must be met by the member states in order to form a monetary union.

A first criterion is labor and capital mobility, as defined by Mundell in 1961. As capital is considered to be mobile, the criterion is built on the idea that labor must be mobile in order to solve the problem of unemployment. Thus, in a currency area that meets this criterion, the need to change the real prices of the factors of production is very likely to be lower [1].

Another criterion is the one set by McKinnon, which regards economic openness. Therefore, countries that are very open to trade and trade a lot with each other form an optimum currency area, because the higher the degree of economic openness, the better will the domestic price level reflect the changes in the international prices of goods.

In addition, Kenen argues that production diversification is a precondition for the optimum currency area. According to him, countries that sell a varied range of goods are less vulnerable to sector-specific shocks [5]. Thus, those countries are less inclined to use the exchange rate as an adjustment mechanism and, therefore, the costs of abandoning their own currency are lower. In other words, diversification acts as a shock absorber.

Another criterion which is extremely important for an optimum currency area in the short term, when the adjustment process practically reflects the necessity to absorb a shock in the economy, is price and wage flexibility. Thus, if prices and wages in a monetary union are flexible, the adjustment process will not end up with unemployment in one country and inflation in another. On the contrary, wage and price flexibility will reduce exchange rate changes. In contrast, if prices and wages are somewhat rigid, flexibility can be achieved by the exchange rate mechanism.

Ingram [6] draws the attention on an equally important criterion, financial integration. The more financially integrated the countries of a union are, the easier it is for the countries facing adverse shocks to obtain funds for boosting production. Fleming believes that the similarity of inflation rates is also a criterion that should not be neglected. Countries that are part of a monetary union should have similar inflation rates. The criterion regarding political integration refers specifically to fiscal integration, homogenous preferences and the conflict between solidarity and nationalism. Thus, if monetary integration is followed by the integration of the fiscal transfer system, then the latter will reduce the need to adjust the exchange rate after a shock, as fiscal integration will practically help the region or country hit by that shock.

A final criterion of the OCA theory refers to the similarity of shocks and business cycle synchronization. Asymmetric shocks and asynchronous business cycles are the greatest threats to the optimality of currency areas. The similarity of shocks is considered to be a prerequisite, a meta-precondition, as it was named by Mongelli [7]. It is known that countries experiencing large and asymmetric macroeconomic shocks face significant costs when giving up their monetary policy independence, which could have served to counter

these shocks. At the same time, if the business cycles of the monetary union member countries are not synchronized, a common monetary policy can not simultaneously stabilize all economies. However, according to Mundell, in a currency area characterized by a high degree of financial integration, the similarity of shocks, although desirable, is no longer a prerequisite [7].

3. The premises of a stable monetary and financial system

Soto [8] mentions three conditions for a stable monetary and financial system, namely:

The first condition regards the complete freedom of currency choice. A single international currency which is not well managed can be much worse than a national currency. Notable in this regard is the contribution of the Austrian economist Fr. Von Hayek which can be found in the work *Denationalization of Money*. The above author recommendation is to change the constitutional rule regarding money. Therefore, the government would be stripped of the money issue monopoly, which would further on be produced under the auspices of competitiveness. Some of the effects of competition are presented below:

(a) a money generally expected to preserve its purchasing power approximately constant would be in continuous demand so long as the people were free to use it;

(b) with such a continuing demand depending on success in keeping the value of the currency constant one could trust the issuing hanks to make every effort to achieve this better than would any monopolist who runs no risk by depreciating his money;

(c) the issuing institution could achieve this result by regulating the quantity of its issue;

(d) such a regulation of the quantity of each currency would constitute the best of all practicable methods of regulating the quantity of media of exchange for all possible purposes [9].

The main idea exemplified by the Austrian economist is that the government should not be the one to take decisions; the choice should belong to the forces of the market. This exclusive right to issue currency, granted to the government, only led to increased government power. Competing issuers would be able to offer individuals much more suited currencies than the government ever did; monetarists have also noticed the beneficial effects of the policy exemplified by the Austrian economist.

The second condition concerns a free banking system, which involves the absence of any privilege and also any governmental control by the means of the central bank. In order to explain the second condition, we shall start the analysis with the supreme criterion that distinguishes two important schools of thought: the Monetary School (the monetarists), which militates in favor of financial solvency and economic stability by creating a central bank, under the hope that monetary abuses would no longer exist, and the Banking School (the bankers), which defends free-banking, based on inflationary reasons. The investigations carried out in the field show that breaking the rules, either by the government institutional coercion or by favoring different interest groups, would only lead to negative consequences, which would affect the spontaneous process of social cooperation. Once the public has an alternative, it would become impossible to determine it to keep cheap money, and the desire to get rid of the money threatening to depreciate would lead to its disappearance, as the Austrian economist Fr. Hayek had noticed.

The third condition supposes that all agents connected to the free banking system are obedient and generally follow the traditional legal principles and rules and, in particular, the principle according to which no one, not even the bankers, are allowed to enjoy the privilege of being able to lend something that has been deposited under the form of a demand deposit (that is maintaining a banking system with 100% compulsory reserves). The traditional rule which is violated in banking is the principle of law according to which in the deposit contract of fungible money (also called "irregular deposit"), the traditional obligation of custody, an essential element of all non-fungible deposits, requires that, a reserve of 100% of the amount of fungible money received as a deposit is to be kept at any time. This means that any document that makes use of this money, particularly granting loans on their behalf, is a violation of this principle and, in short, an illegitimate act of fraudulent misappropriation [8].

Yet, the reserve of 100% has tempted bankers to violate the traditional rule, by using depositors' money for personal benefits. At the beginning, they realized that this was illegal and operated in great mystery; after

the government imposed the privilege of using depositors' money, the whole process was conducted openly. It is this advantage or easement that violates property rights, as seized by Mises as well. Thus, each bank internalizes all profits from its credit expansion, and their corresponding costs are transmitted to the entire banking system and the only method of eliminating the human influence on the credit system is to suppress any further issue of fiduciary means [8].

4. Conclusions

The present study has been conducted on the basis of the classical theory of optimum currency areas, which examines both the benefits that can be obtained from the process of economic unification as well as the costs involved by the creation of an optimum currency area. Starting from Mundell's work and continuing with names like McKinnon, Kenen and others, we have tried to highlight the main features and criteria that allow the existence of an optimum currency area.

Therefore, labor and capital mobility, economic openness, production diversification, price and wage flexibility, financial integration, similarity of inflation rates, political integration, synchronization of business cycles and the similarity of shocks not only serve as guidelines in assessing the costs and benefits of an optimum monetary arrangement but also as the main criteria to be met in order to improve the situation and make the existence of the optimum currency area possible.

In the last part of the study we have focused on the need for a stable monetary and financial system. The methodological mistakes together with the coercive practices of the government create an unstable environment in which the principle of law is violated. Emphasizing and analyzing the main conditions that need to be obeyed was meant to warn us not to repeat the mistakes of the past.

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