# Vulnerability of Monetary Unions in Times of Crises

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During the past couple of years, the world has witnessed a series of shocks that have deeply impacted the global economy. Starting with the emergence of the coronavirus pandemic, which reached its peak during the years 2021 and 2022, major economies confronted their first major headwind in decades. Lockdowns spread led to the shutdown of production activity sending thousands of workers home. In order to sustain their demand and compensate for their job losses, central banks intervened to inject liquidity. Another major impact on the global economy was disruptions in supply chains. As predicted, inflation would be highly expected. Shortly after the pandemic shrank and production returned to life again, another major shock hit in February 2022: the Russian-Ukrainian war. This war has not only sent oil prices above one hundred dollars per barrel, but it has also threatened the global supply of natural gas, wheat, and essential edible food products. With political considerations taken into account, the opinion of states regarding Moscow determined their supply of gas, especially for the European ones. As a result, prices continued to increase while uncertainty remained dominant on the horizon. Recently, the latest military escalations occurring in the Middle East also have their probabilities of affecting the world by reducing shipment activities.

Amid this briefing, serious concerns are rising regarding economic vulnerability and crises. After injecting stimulus checks, inflation deviated sharply from the 2% level agreed upon. Accordingly, instability led nations to consider national security among their priorities. In other words, close countries were seeking to strengthen their relations with geographically close countries in order to avoid long-distances risks.

Given that monetary policy has been expansionary during the last couple years and now it is aimed at a contractionary path, how were major economies impacted? More interestingly, when considering a high degree of formal economic integration, did monetary unions perform better than others during these crises? Almost every "capitalist" economy adjusted its policy to address the challenges. However, when monitoring the main macroeconomic variables for major economies, one of the main results that can be deduced is that the performance of some individual countries differed from that of unified ones (figure 1). Said differently, the European Union is the economic entity that is suffering the most. Constrained by the European Central Bank's (ECB) general policy, all countries in the Union follow the same policy regardless of their weak or powerful economies.

This paper aims to explain the vulnerability of monetary unions. Thus, it will present the work done about this topic by highlighting first the theoretical background of monetary unions, then the aspects related to the political economy of monetary unions, and lastly, it will reflect relevant empirical findings, mainly related to the European Union.

## Inflation Rate in Main European Countries
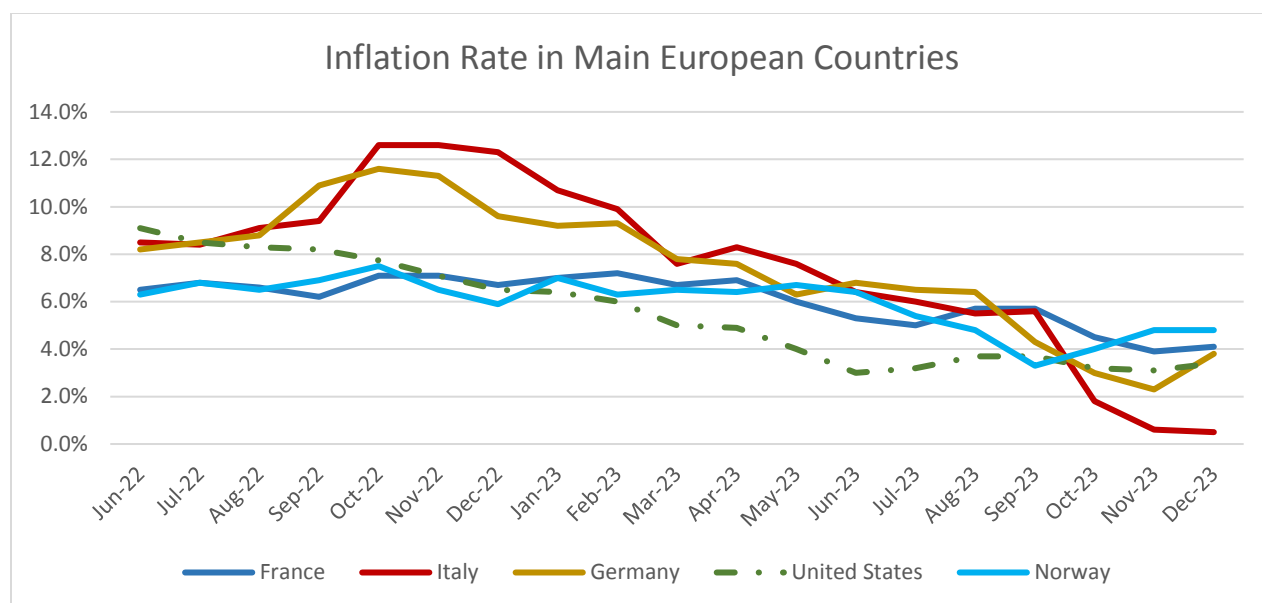
*Source: Trading Economics*

### I-      *Theoretical Background*

This paper presents the work that has been done regarding monetary unions. To start with, setting the theoretical base is addressed in this section. Monetary unions are formally known as Optimal Currency Area (OCA). The main objective of such areas is to make geographically close nations adopt one currency, which would lead to greater economic welfare (Mundell, 1961). Within this line of thinking, it is worthwhile to consider the ECB's commitment to preserve the purchasing power of the Euro and keep inflation within the limits of 2%.

The idea of OCA was first introduced by Robert Mundell. In his paper "A Theory of Optimum Currency Areas", Mundell (1961) starts by defining a currency area as a domain having a fixed exchange rate and asking the question of what it would take to form such an area. Within his analysis, he distinguished three aspects that would indirectly answer the question. The first is its consideration that the world is witnessing a process of economic integration, and currency areas would serve as an experiment for this rising model. Second, he acknowledged the risks associated

with a currency area when the national currency does not align with that of the OCA. Third, he aimed to clarify the economic impact of currency, which was not adequately expressed in the literature and was not considered in economic policies.

According to Mundell (1961), a monetary area requires the presence of one central bank. However, if each country has its own central bank, these independent banks have no ability to conduct individual monetary policy. His model consists of two countries: A and B. A sudden shift of demand from one country to another would cause unemployment and inflation in A and B, respectively. For an OCA to succeed, it should adopt a flexible exchange rate. However, Mundell (1961) identifies four pillars for a successful OCA: high factor mobility across the area, price flexibility, a risk sharing strategy between the members, and proximity among their business cycles.

Shortly thereafter, several economists relied on Mundell's OCA initial model and expanded the line of thought. (McKinnon, 1963) proposed a mathematical model of a monetary union in the context of an open economy. Furthermore, he assumed three objectives for setting the exchange rate: full employment, balanced international payments, and a stable internal average price value. In his analysis, he adds on Mundell by considering trade among the area in what he refers to as "exportables and importables." Moreover, he points out that an increase in tradeable goods leads to price fluctuations. Hence, OCA acts by reducing the share of tradables, which leads to price stability. Accordingly, McKinnon reveals the limitations of his model. These limitations are regarding the classification or identification of tradable goods and non-tradable goods. Also, his model mainly addresses the case of a small area in which prices are not externally or internally impacted.

In continuation of this process, another work was established to further develop the model of OCAs. Grubel (1970) explains the formation of a currency area while considering welfare. Accordingly, he built his analysis on three pillars: the level of real income, its stability, and the degree of national economic dependence.

Regarding the level of income, integration reduces uncertainty level. This makes firms expand and specialize in their production. Moreover, stability is increased under a union only if the shocks that occur for member countries are not positively and perfectly correlated. Also, Grubel (1970) argues that, economic independence is difficult to achieve given the fact that countries within a union have inflation rates, as well as interest rates different from one another. As a result, countries that decide to join a monetary union might be forced to conduct policies that are less socially optimal, mainly in terms of employment and growth rates. Hence, OCA might reduce welfare. In contrast, positive outcomes can be generated from joining an OCA, such as a more transparent monetary policy, increased investments, lower exchange rate fluctuations that are driven by speculative attacks and an increased trade activity with a lower transaction cost.

Some early work has focused on the problems and obstacles that might arise from an OCA. Ingram (1973) argues that, the transition to a monetary union is among the most challenging steps in the process because entrants need to reduce the disparities in wages and price fluctuations. Accordingly, Tavlas (1994) identifies two main problems for countries under a monetary union. The first problem is regarding inconclusiveness. He explained it by giving the example of when two countries have a satisfactory level of trade between them and decide to integrate. Then, if a country has low factor mobility, it might be obliged to fix its exchange rate. The second problem is a problem of inconsistency. By inconsistency, he means that small economies have the interest to be integrated within monetary unions, but they are structurally different from larger members.

Having set the theoretical background for OCA, the next section will address the considerations related to the political economy of union formation.

### II-    The Political Economy Lens

When deciding to be part of a union, politics come into play. Mintz (1970) argues that, the importance of political will is among the major considerations aligned with the creation of a union. The will in politics is meant to open the doors for collaborations regarding economic policies. Accordingly, consistency is a pillar for an OCA to succeed. Haberler (1970) emphasizes that policies should be similar across the union to secure a resilient currency area. In addition to that, the role of policymakers is essential in a monetary union. In order to have a strong currency area, a comprehensive vision of the macro-economy needs to be realistic among members, and policymakers need to have the wisdom to accept the tradeoffs involved when being integrated into a monetary area (The Theory of Optimum Currency Areas and Exchange Rate, 1976).

An essential element when considering the political economy of a monetary union is the concept of the "Impossible Trinity" also known as the "Trilemma" (Obstfeld, 1994). This trilemma, which originates from the Mundell-Fleming model, pushes countries to adopt a constrained monetary and international policy. In other words, it involves a tradeoff among the policies. In the context of the Eurozone, members are towards adopting the side A involving exchange rate control and free capital mobility.
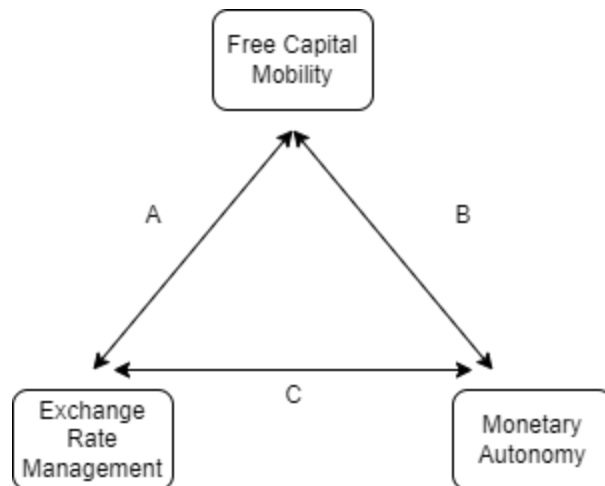
*Figure 1: The Impossible Trinity*

The cost of the tradeoffs might increase when countries are interconnected while being different. Corden (1972) argues that, being part of a currency area makes the country lose its legitimacy and exclusive control over its national monetary policy and the rate of its currency exchange.

The political aspect of an OCA is complementary to the economic process to satisfy its implementation. According to Issing (2000), the integration process has three essential pillars that start with economic integration, which is followed by monetary integration, and are then grouped under political integration. This is also in line with the Treaty of Rome established in 1957 which acts as the foundation of the European Economic Community (ECC).

### III- *The Case of the Eurozone*

The aim of this review is to present the reasons that lead to the vulnerability of monetary unions. For this objective, the case of the European Union will be taken. Concerns related to the Eurozone have been raised during the crisis of Greece. Recently, these concerns have increased with the performance of the Union amid the latest developments.

Under unions, market sentiments play an essential role. For countries that are part of a monetary union, market sentiments act as a main determinant of vulnerability. Under such unions, countries cannot adjust their budgetary policies independently, especially in times of uncertainty (Grauwe, 2012). The main monetary policy adopted by the union pushes some members into a bad equilibrium. Accordingly, asymmetric information can appear. Moral Hazard problems arise when the union's central bank provides insuring insights that lead to increased lending activity for weak members.

As any economic entity, a union is subject to shock. However, when different countries are joined under one union, the magnitude of the shock differs. A shock facing the Eurozone has its biggest impact on the most isolated and economically weak countries ( Fingleton Garretsen Marti, 2015). By using a spatial panel data model, the authors found that current Eurozone countries are not symmetric in the way that conforms to an optimal monetary union. Also, they expressed that the period prior to the financial crisis created the illusion that the Eurozone was successful. As a recommendation, they mentioned that the countries that want to join the European Union need to have a serious assessment of the potential impacts that follow this integration.

To start with the empirics, an event that impacted heavily the European Union is the Brexit. As mentioned in the theoretical part, a successful monetary union relies on high factor mobility. By exiting the EU, Britain has decreased this level of mobility for labor and capital as well. Similarly, Brexit will lead to a tighter job market and increased transaction costs between the two parties. Also, currency fluctuations should be expected (Chen et al., 2018). Moreover, Brexit is likely to cause a decrease in the economic power of the European Union, especially regarding trade and GDP (Holobiuc ,2018).

Disparities among members are a main cause of the vulnerability of the Eurozone. Similarly, Saint-Paul (2010) argues that the imbalances in the European Union are identified as countries with a 2% inflation rate, while others have higher levels. Accordingly, the European Union has a group of countries that have a trade surplus balance, while others are largely indebted. Spain can serve as an example. After joining the EU, Spain witnessed unsustainable growth driven by a housing boom, which is a non-traded good.

To enhance the resiliency of the Eurozone, vulnerable governments that face market problems need to be bailed out by the ECB and proceed with an effective reconstruction of their debts (Haidar, 2014). Also, banks need to be recapitalized. Hence, the problem of Moral Hazard should be addressed to investors who should become aware that European governments can actually default.

With more recent global shocks, the outlook for the Eurozone has been diminishing. Di Bella (2022) argues that the Eurozone's economic outlook has darkened and proved its vulnerability following the Russian-Ukrainian War. Also, the pandemic has heavily affected the Eurozone area. Gross indebtedness rose considerably after the pandemic. The gross debt to value-added ratio grew almost 20% between 2019 and 2021, reaching a peak of nearly 165%. Also, this debt is unevenly distributed among the firms, raising a micro-economic threat. Firms that have sales below the median increased their debts by 3 percentage points (Giulio Nicoletti, Ralph Setzer, Mika Tujula and Peter Welz, 2023).

The repercussions of the major shocks are leaving the European Union in a dangerous situation. The growth in the EU is under negative forecast due to high inflation and the contractionary monetary policy that is blocking the economic activity in the whole block. The differences among

members are raising serious concerns because, in some countries, inflation is cooling down while in others it remains high, especially for food products. Also, inflation has disproportionately affected the region's real disposable income. Moreover, the substantial change in the performance of strong countries in the union has spread the burden across all the members. Two examples of that are Germany and Italy. Germany has witnessed a severe decline in its economic performance due to its tight dependency on Russia's gas. Italy is facing financial stress due to its investments in Russia and its high level of government debt, which reached 155% of GDP in 2020 (World Economic Forum, 2023).

**Concluding Remarks and Recommendation**

The recent events that have deeply impacted the world have revealed the weaknesses that major economies suffer from despite being powerful entities. The policies adopted previously to sustain demand led to inflationary pressures, which required a contractionary monetary policy. As a result, interest rates were increasing in several economies. However, because of the heterogeneity of the current capitalist system, some nations have succeeded in achieving a smooth recovery process, while others are still suffering from the burden supplemented by such policies.

Regrouping several economies under one entity seemed to present a resilient model capable of increasing economic welfare for its members in times of peace and confronting major exogenous shocks in times of distress. However, the recent period has proved the contrary. Countries under one union do not only share the shocks among them but also share their burden within the union to which they belong. By considering the case of the European Union, the vulnerability of monetary unions can be emphasized. Hence, several deductions can be made. First, monetary unions need to prove their success as they are highly vulnerable in times of shock. Second, a

monetary union with a large economic divergence between its members is not resilient. Third, political considerations play a crucial role not only in setting the path of the union, but they also set its condition in relation to factor mobility.

These facts about the vulnerabilities of the monetary union present an important lesson for future political coalitions seeking economic dominance. The BRICS, which is currently a rising coalition, plans to induce a change in the prevailing capitalist economy. The group is considering its expansion to allow several states to join. By just holding the economic considerations and excluding the political ones, the coalition is currently highly heterogeneous and is expected to become even more diverse as other economies join. Additionally, the most important point worth mentioning about the Brics is its long-term objectives to establish a unified currency among its members. Hence, based on the current experience that has been described in this paper, great challenges await.

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