4.4 The Common Currency Debate

A debate related to volatile exchange rates and their effects on trade concerns common currency areas, in which exchange rates are fixed or a common currency is shared between countries.[32] The risks associated with volatile currencies are removed in such a system, but the debate on the merits of fixed versus flexible exchange rates encompasses a number of other issues.

The essence of the debate over fixed versus flexible exchange rates is whether one believes the benefits of one arrangement outweigh its costs. In the adoption of one system, its costs are the foregone benefits of the other system. So, we need only consider the costs and benefits of either the fixed or flexible exchange system and, by definition, we will also have the costs and benefits of the other.

The significant costs and benefits of a common currency area are summarized in Table 1.

TABLE 1
BENEFITS AND COSTS OF A COMMON CURRENCY

BENEFITS	COSTS
1. Reduced transactions costs	1. Reduced policy independence.
2. Reduced economic uncertainty.	2. Less insulation from foreign economic disturbances.
3. Enhanced policy discipline and credibility.	
4. Improved functioning of the monetary mechanism.	

Source: *The Exchange Rate and the Economy*, Bank of Canada, 1993, p. 489.

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[32] For simplicity, this Paper will not differentiate between a system of fixed exchange rates and a common currency area. In fact, the two are quite different. With a fixed exchange rate, macroeconomic divergences can build up and put pressures on currencies to adjust, as happened in Europe in 1992 and 1993. In a common currency area, monetary policies would not be allowed to diverge. In fact, for a common currency area to work, it would require a single monetary policy, possibly set by a cross-country central bank.