

Crockett says that liberalized financial flows are an essential element of free trade.³⁵ He maintains that greater cooperation in exchange rate policies is required, since the large capital movements within a free trade area could lead to exchange rate instability. Crockett concludes that the financial integration that accompanies free trade may necessitate a currency zone.

Free Trade Does Not Require a Common Currency

Laidler explains that the situations in Europe and North America with respect to the requirement for, and feasibility of, a common currency are quite different.³⁶ In Europe, a common market is being created, within which a degree of national sovereignty has already been foregone. In North America, there exists only a free trade area, and the surrender of national sovereignty associated with a common currency would extend the countries' obligations well beyond those usually associated with free trade. This is a political, as well as an economic, argument.

There are other objections to common currencies beyond the concerns with the loss of policy independence and national sovereignty. Feldstein notes that there are cases in which a common currency is actually an obstacle to trade.³⁷ If two countries with a common currency are engaged in trade, and a third country's currency depreciates, exports from the third country become more competitive in the common currency area. It is possible that some trade between common currency countries would be displaced by the third country. By not being able to alter exchange rates, the market shares of member countries can vary within a common currency area.

4.5 Financial Instruments to Reduce Risk

Presumably, the higher risks faced by firms trading internationally -- which include exchange rate risk and political risk as well as standard business risks encountered in all markets -- are matched by higher returns for those that continue to

³⁵ See A.D. Crockett, "Financial Market Implications of Trade and Currency Zones." In *Policy Implications of Trade and Currency Zones*. Kansas City: Federal Reserve Bank of Kansas City, 1991, pp. 111-36.

³⁶ See D.E.W. Laidler, "One Market, One Money? Well, Maybe. Sometimes." In *Policy Implications of Trade and Currency Zones*. Kansas City: Kansas City, 1991, pp. 85-6.

³⁷ See M. Feldstein, "Does One Market Require One Money?" In *Policy Implications of Trade and Currency Zones*. Kansas City: Federal Reserve Bank of Kansas City, 1991, pp. 79-80.