With respect to the effects on international trade, the decision on whether to adopt a fixed exchange rate or enter into a common currency area essentially rests on three questions:

(1) Is the exchange rate excessively volatile?

(2) If the exchange rate is volatile, does that represent an impediment to trade?

(3) If volatile exchange rates are an impediment to trade, is the removal of that impediment worth the surrender of sovereignty required to fix exchange rates?

4.4.1 Free Trade Areas and Common Currency Areas

There is no widely accepted relationship between free trade areas and common currency areas. Some researchers feel that the gains from free trade can never be fully realized without a common currency. They tend not to address, however, the role of the exchange rate as an adjustment mechanism.[33] Others suggest that common currency areas require more than free trade agreements. A common currency is viewed as being as much a political decision as an economic one.

Free Trade Requires a Common Currency

Those who favour a common currency consider the volatility of exchange rates to be sufficient to deter international trade.[34] They favour giving up an independent monetary policy in order to do away with the uncertainty of volatile exchange rates as well as the resource misallocation and adjustment costs associated with medium-term exchange rate movements that are often unrelated to economic fundamentals.

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[33] It is important to remember that if, by virtue of being fixed, exchange rates are not allowed to adjust for macroeconomic divergences, other variables will need to do so. For a brief discussion of how fixed exchange rates require certain policy actions to keep them fixed, see T.C. Mills and G.E. Wood, "Does the Exchange Rate Regime Affect the Economy?" In *Review*. St. Louis: The Federal Reserve Bank of St. Louis, July/August 1993, Vol.75, No. 4, p.4. Specifically, Mills and Wood mention the necessity of exchange rate intervention and short-term interest rate manipulation. They cite several other studies that suggest the adoption of a system of fixed exchange rates results in the replacement of exchange rate variability with interest rate variability.

[34] See R.G. Harris, *Trade, Money and Wealth in the Canadian Economy.* Toronto: C.D. Howe Benefactors Lecture, 1993, pp. 41-7.