Monetary Policy Spillovers & Optimum Currency Area

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Impossible trinity

MP Spillovers: Channels

• Exchange rate channel
• Domestic demand channel
• Financial spillovers channel
MP Spillovers: Exchange Rate Channel

- Mundell-Fleming model and its implications

- Country A (small open economy)
- Country B
- Exchange rate not fixed
- Open capital account
- Expansionary MP in country B

Expenditure-shifting effect
MP Spillovers: Domestic Demand Channel

Country A

Exports ↑
GDP ↑

Country B

Domestic demand ↑
Imports ↑

Expenditure-increasing effect
MP Spillovers: Financial Spillovers Channel

Country A

Investment ↑

GDP ↑

Country B

Expansionary MP

Yields on financial assets ↓

Expenditure-increasing effect
MP Spillovers: Examples

- US
- EMEs
Optimum Currency Area (OCA)

• a geographical region in which it would maximize economic efficiency to have the entire region share a single currency
OCA: Four criteria

• common shocks
• symmetric shocks
• common responses
• idiosyncratic shocks
OCA: Benefits

• Currency convenience
• Transparency of prices
• Cross-border investment

• Additional benefits
OCA: Disadvantages

- No independent stabilisation, growth and other policies
- Common shock, common response
  - Eurozone debt crisis (2010)
OCA: Examples

• Eurozone

• US BEA regions:
  • New England, Mideast, Great Lakes, Rocky Mountains and Far West
  • Southeast, Plains and Southwest
Works Cited


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