

The Demise of the Dollar and the Rise of Regionalism: A Theory of Optimum Anchor Currency Areas

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Since Robert Mundell published his seminal work on optimum currency areas (OCAs) in 1961, there has been an enduring academic debate on the modalities and the viability of currency blocs.¹ The creation of the European Monetary Union has given a new impetus to research on regional monetary integration. This paper analyzes a similar regional monetary regime: an optimum anchor currency area (OACA). An OACA is a regional grouping of countries that peg their currencies to the same anchor currency. This paper examines the rationale for such a regional anchor bloc and proposes a theory of optimum anchor currency areas.

The U.S. dollar has long been at the center of the international monetary system and continues to influence the exchange rate regime choices of many countries. A number of influential scholars today question the long-term viability of the dollar as the international vehicle currency and as the dominant reserve and anchor currency.² First, the adoption of a common currency in Europe has established the euro as an alternative to the dollar. Along with other economists, Chinn and Frankel argue that the euro may soon rival the dollar as the dominant international currency.³ In their view, a potential euro-dollar rivalry may give rise to a general reorientation in international anchor choices. At the same time, the high and increasing level of the U.S. national debt may raise questions about the sustainability of U.S. borrowing. The notorious “twin deficits” (the current account and budget deficits) have increased the national debt to an unprecedented \$12 trillion as of November

¹ Robert Mundell, “A Theory of Optimum Currency Areas,” *American Economic Review* (November 1961): 509–517.

² Menzie Chinn and Jeffrey Frankel, “Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?” in *G7 Current Account Imbalances: Sustainability and Adjustment*, ed. R. Clarida (Chicago: University of Chicago Press, 2007): 283–322.

³ *Ibid.*

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2009.⁴ The growing national debt increasingly puts pressure on the Federal Reserve to monetize deficits. Inflationary monetary policy would result in a depreciation of the dollar, thus putting the value of worldwide central banks' reserve holdings at risk.

These factors may cause central banks to diversify their reserve portfolios and move away from the dollar. This move would be a plausible example of an international economic shock that would give rise to a reappraisal of anchor choices. Such a shock may induce one or several countries to abandon their pegs to the dollar. Once these countries move to a different regime, this may produce a bandwagon effect, causing other countries to follow suit.⁵ In this way, an international economic shock could well result in a general shift away from the dollar. This shows how small changes in anchor choices can lead to large and rapid effects on the international monetary system. As a result, the international monetary system may be less stable than indicated by the relative continuity of regime choices in recent years.⁶

This paper argues that in the event of a shock affecting the international role of the dollar, regional currency regimes could emerge. In particular, former pegs to the dollar could be transformed into pegs to a regional currency, resulting in regional anchor blocs. In analogy to Mundell's theory on Optimum Currency Areas (OCAs), these regional blocs could be analyzed under the framework of an "optimum anchor currency area" (OACA). The idea of an OACA was first introduced by Meissner and Oomes.⁷ The case for OACAs begins with the finding that the choice of anchor currency in the international monetary system is based on trade network externalities. To capture the benefits of these externalities, countries follow the anchor choices of their trading partners rather than considering the intrinsic qualities of their anchor currencies. Therefore, network externalities imply path dependence of anchor choices. As a result, multiple equilibria of anchor patterns exist and countries can be locked in to a suboptimal equilibrium. This paper argues that regional anchor blocs may constitute a superior equilibrium.

The rest of the paper is organized as follows. Section 2 provides the theoretical underpinnings, building on the theories on pegged exchange rate regimes. Section 3 discusses the economic costs and benefits of OACAs. Section 4 gives a practical example of a potential OACA in South America. Section 5 concludes by summarizing the key findings.

⁴ U.S. Treasury, "The Debt to the Penny and Who Holds It," <http://www.treasurydirect.gov/NP/BPDLogin?application=np> (accessed on 11/17/2009).

⁵ Marc Flandreau and Clemens Jobst, "The Empirics of International Currencies: Network Externalities, History and Persistence," *The Economic Journal* 119 (2009): 643–664.

⁶ Christopher M. Meissner and Nienke Oomes, "Why Do Countries Peg the Way They Peg? The Determinants of Anchor Currency Choice." Washington, DC: International Monetary Fund, IMF Working Papers 05/2008.

⁷ Meissner and Oomes 2008.

PEGGING AND ANCHOR CHOICE IN THE INTERNATIONAL MONETARY SYSTEM

Motivations Behind Pegging

A country's exchange rate policy can achieve a variety of goals. The three principal goals are 1) to keep domestic inflation in check, 2) to provide exchange rate stability, and 3) to accommodate the macroeconomic goals of growth and employment.⁸ All three goals are relevant for any given regime, although the pursuit of one or two goals usually dominates. Goals may be mutually exclusive in the sense that the pursuit of one or two goals precludes the pursuit of the other one(s). For example, under high international capital mobility, it is impossible for a country to have a pegged exchange rate *and* an independent monetary policy. This constraint is known as the "unholy trinity."⁹ By pegging the currency to an anchor, a government gives up its monetary policy to support the exchange rate. As a result, it gives priority to the goals of low inflation and exchange rate stability.

First, pegging can help achieve low inflation by restricting the government's ability to expand the domestic money supply. The domestic money supply is effectively tied to that of the anchor country, which locks in a low-inflationary monetary policy. For countries with histories of high inflation, pegging to a low-inflationary currency effectively "imports" discipline and credibility. Here, discipline means limiting the scope for "printing money" in order to monetize fiscal deficits and ratify wage increases. Credibility refers to establishing the belief in the markets that the central bank will not inflate the money supply.¹⁰ By pegging to an anchor currency, a country can benefit from price stability.

Second, the objective of the exchange rate stability approach is to avoid undue fluctuations in the exchange rate. Exchange rates are often subject to high volatility, and their movements often do not reflect economic fundamentals; in particular, exchange rates can overshoot and reflect herd behavior among investors and speculators. A strong commitment to a certain target rate reduces uncertainty for traders and investors. As a result, pegging lowers transaction costs by reducing the risk implied by uncertainty. Pegging also reduces transaction costs more generally by providing a stable anchor for international transactions related to trade and investment. A stable exchange rate eliminates the costs of hedging, calculation, and confusion.¹¹

Types of Pegging

There are a number of different ways to peg a currency. They differ primari-

⁸ W. Max Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge, MA: MIT Press, 2000).

⁹ *Ibid.*

¹⁰ *Ibid.*

¹¹ Luca Antonio Ricci, "A Model of an Optimum Currency Area." Washington, DC: Research Department, International Monetary Fund, 2008.

ly in terms of the commitment to the exchange rate. Pegged regimes can broadly be classified in the categories of “soft” pegs, “hard” pegs, and those pegs involving the adoption of the same currency. Figure 1 illustrates the most important regime choices regarding pegs.

*Figure 1: Classification of Pegged Regimes by Strength of Commitment*¹²

Low Commitment: “Soft” Peg	High Commitment: “Hard” Peg	Absolute Commitment: Same Currency
<i>Flexible Peg</i> (frequent adjustments)	<i>Currency Board</i> (adjustments require constitutional amendment)	<i>Dollarization</i> (unilateral adoption of foreign currency)
<i>Crawling Peg</i> (periodic adjustments)	<i>Fixed-But-Adjustable Regime</i> (FBAR, no or rare adjustments)	<i>Monetary Union</i> (multilateral adoption of common currency)
<i>Target Zone</i> (band)		

For the purpose of this paper, three regimes are of particular importance: the fixed-but-adjustable regime (FBAR), the target zone, and monetary union. The *FBAR* implies a high commitment to the anchor, and the exchange rate is adjusted only reluctantly. Under a *target zone*, if the band is relatively wide, the regime can be considered as a managed floating regime. If the band is narrow, the regime more closely resembles an FBAR.¹³

The regime of a *monetary union* will serve as a benchmark to evaluate regional anchor blocs. As shown in the table, the absolute commitment of adopting a common currency is the key difference between a monetary union and both the FBAR and the target zone.

The Dynamics of Anchor Choice in the International Monetary System

A number of studies have investigated the empirical determinants of anchor currency choice.^{14, 15, 16} These determinants include the symmetry of business cycles and output shocks, the denomination of a country’s liabilities, and a country’s previous history of anchor choice. The key determinant of anchor currency choice, however, is captured by *trade network externalities* (TNEs). TNEs refer to the savings in transaction costs that accrue to the anchoring countries when other countries use the same anchor currency. *Ceteris pari-*

¹² Own illustration, adapted from Corden 2000.

¹³ Corden 2000.

¹⁴ Meissner and Oomes 2008.

¹⁵ Etienne B. Yehoue, “Currency Bloc Formation as a Dynamic Process Based on Trade Network Externalities.” Washington, DC: International Monetary Fund, IMF Working Paper No. 04/222, 2004.

¹⁶ Alberto Alesina and Robert J. Barro, “Currency Unions,” *Quarterly Journal of Economics* 117 (2002): 409–436.

bus, the best anchor is the currency that minimizes transaction cost. Since transaction costs increase with exchange rate volatility, the optimal anchor currency is the one that minimizes the trade-weighted sum of bilateral exchange rate volatilities. These volatilities depend on the anchor choices of trade partners; hence, one country's optimal anchor is a function of other countries' anchor choices.¹⁷

TNEs give rise to a situation of *mutual dependence* in international anchor choice. As countries peg to the same anchors as their trading partners, a bandwagon effect occurs that *reinforces* the use of the dominant international anchor currency. Rather than looking for the intrinsic qualities of their anchor currency, countries follow the anchor choices of their trading partners. This implies that anchor choice is path dependent, meaning that different starting points in the international monetary system may lead to different outcomes.¹⁸ Each of these outcomes may constitute a relatively stable equilibrium of international anchor choice. As a result, multiple equilibria exist regarding anchor patterns in the international monetary system. This means that the actual equilibrium prevailing at any given point in time is most likely a suboptimal equilibrium. This is a situation in which a currency is "oversubscribed" in that more countries peg to a currency than is justified by its intrinsic qualities and economic fundamentals. Flandreau and Jobst argue that the dollar presently constitutes such an oversubscribed currency that has locked countries in to a suboptimal equilibrium.¹⁹ This poses the central question: What would be a superior equilibrium?

This paper suggests an answer to this question. It investigates the configuration of a regional bloc of countries pegging to the same anchor. Analogous to Mundell's OCA theory, such a set-up could be called an "Optimum Anchor Currency Area." This approach uses the theory on Optimum Currency Areas and applies it to a group of countries pegging to a common regional anchor. The European Monetary System (EMS) from 1979 to 1999 provides a historic example of a regional anchor bloc. The next section sets out why an OACA might be preferable to a dominant international anchor.

ASSESSING THE ECONOMIC DESIRABILITY OF OACAs

Economic Rationale for OACAs

An intuitive reason why a regional anchor bloc makes economic sense relates to gravity models of trade, which predict that the volume of trade between neighboring countries tends to be greater because transaction costs are lower. For example, geographical proximity reduces transportation and communication costs and allows trade in perishable goods. This results in a

¹⁷ Meissner and Oomes 2008.

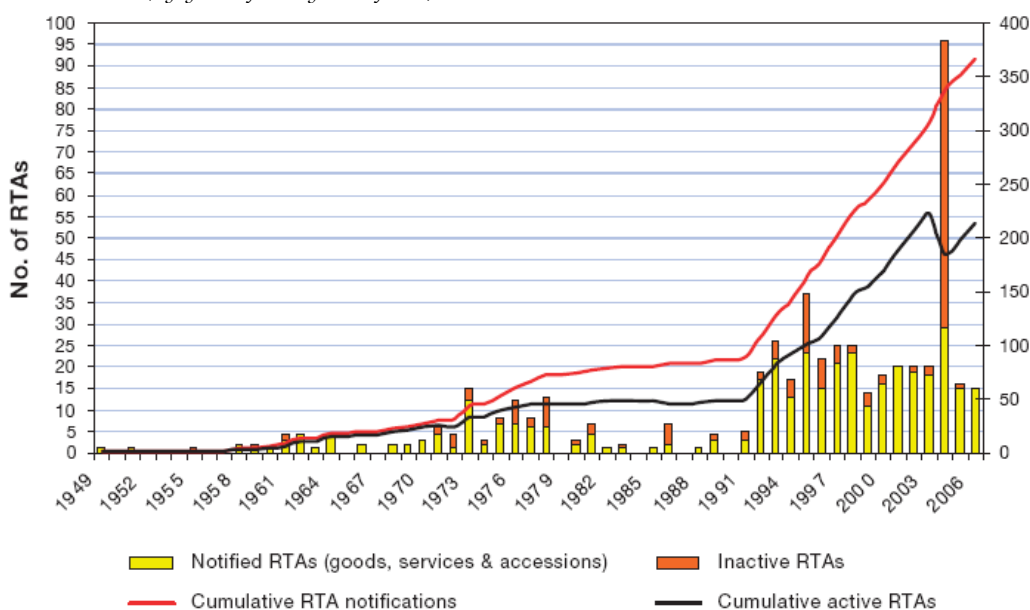
¹⁸ Yehoue 2004.

¹⁹ Marc Flandreau and Clemens Jobst, "The Empirics of International Currencies: Network Externalities, History and Persistence," *The Economic Journal* 119 (2009): 643-664.

preference for regional trade partners. Pegging to a common regional anchor eliminates unnecessary fluctuations in the prices of goods traded between regional partners. Therefore, the greater the intra-regional share of trade, the stronger the case for a regional anchor currency.²⁰

This gravity effect has been reinforced in recent years by a trend towards regionalization in international trade. The growing number of regional trade agreements (RTAs) such as NAFTA, CAFTA, and EFTA are indicative of a global trend towards regional trade integration. Figure 2 illustrates the rapid increase in the number of RTAs since the early 1990s.

Figure 2: All RTAs Notified to the GATT/WTO (1948–2006)²¹
(by year of entry into force)



For a theory of Optimum Anchor Currency Areas, this trend towards regionalization is important for two reasons. First, regional trade agreements are implemented to further increase intra-regional trade, at times to the detriment of non-members.²² As the share of intra-regional trade increases, so do the positive trade-network externalities of a common regional anchor cur-

²⁰ Kevin Dowd and David Greenaway, "Currency Competition, Network Externalities and Switching Costs: Towards an Alternative View of Optimum Currency Areas," *Economic Journal* 103 (1993): 1180–1189.

²¹ World Trade Organization, "The Changing Landscape of Regional Trade Agreements: 2006 Update." Geneva, Switzerland: WTO Secretariat, Discussion Paper No. 12, 2007.

²² Jacob Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950).

rency. If this trend persists, the case for optimum anchor currency areas will strengthen over time.

Second, the growing number of RTAs show that there is a strong political will for regional integration. In many cases, regional efforts go beyond the elimination of trade barriers. Today, a number of regions in the world are trying to emulate the successes of European integration. Examples of regional associations include the Association of South-East Asian Nations (ASEAN), the Gulf Cooperation Council (GCC), and the Southern Common Market (Mercosur). Given the political will for regional integration, a regional anchor bloc may be the next logical step for some regions. This is especially important because the benefits of a common regional monetary regime increase as deeper integration in other areas is achieved. As Eichengreen argues, "the deeper is integration [...] the more intense will be the political dislocations associated with a sudden shift in the exchange rate."²³ In other words, a deepening of regional integration favors exchange rate regimes with a regional anchor.

Design of OACAs

The advantages described above have largely been captured by the theory of Optimum Currency Areas (OCAs). OCA theory discusses the costs and benefits of monetary union. The OACA approach is similar in many respects to OCA theory. The principal difference is the weaker commitment in the case of an anchor bloc and the flexibility that comes with it. As a result, an Optimum Anchor Currency Area has one important disadvantage and two principal advantages over a full OCA. The downside of an OACA is the potential vulnerability that is connected with the relatively weaker commitment to the regional anchor. It is much easier to abandon a regional anchor than a common regional currency, which may put the long-term success of a regional anchor bloc at risk.

One of the primary advantages of an OACA is that countries are not required to give up their national currency. Issuing a currency is an important symbol of national pride and sovereignty.²⁴ Giving up this sovereignty is very hard to achieve and requires exceptional political will. Under an OACA regime, countries would not need such extraordinary political will to form a regional monetary regime.

Second, an OACA can be designed in a number of different ways to fit the needs of the regional members. A range of instruments can be used to design a regional monetary regime with an appropriate level of commitment. In particular, the following options are conceivable:

²³ Barry Eichengreen, "Does MERCOSUR Need a Single Currency?" Cambridge, MA: National Bureau of Economic Research, NBER Working Paper 6821, 1998.

²⁴ Yehoue 2004.

- The anchor can be a hegemonic regional currency, a basket of regional currencies, or (in a wider sense) an extra-regional unit such as the Special Drawing Rights (SDRs) of the IMF.
- The regional member countries can have the same or differing pegged regimes vis-à-vis the anchor.
- Regional members can fix their currency within a target zone. If they do, there can be a relatively narrow or wide band and a relatively strong or loose commitment to the band.
- The peg could be crawling or not. If it is crawling, it could be an active or a passive crawl.
- In addition, the commitment to the peg could be bolstered through a currency board and/or capital controls.

An in-depth evaluation of these various options is beyond the scope of this paper. For the purpose of the subsequent analysis, the common features of OACA regimes are more important than the differences. In OACAs, substantially all countries within a region share the same anchor. This anchor is not the currency of an external country, but one within the region or some basket of currencies.

ASSESSING THE COSTS AND BENEFITS OF OACAS

In order to assess whether an OACA might be a superior configuration of the international monetary system, I will analyze the costs and benefits of such a regional anchor bloc. I will proceed by discussing how the arguments brought forward in the debate on OCAs apply to the case of an OACA.

Benefits of OCAs and Application to OACAs

Lower transaction costs

Robert Mundell's early work emphasized the benefits of reduce transaction costs in OCAs.²⁵ Adopting a single currency eliminates the cost of collecting and processing information related to exchange rates. In addition, the dead-weight losses related to currency transactions become obsolete. A number of studies present empirical support for significant potential savings in transaction costs.^{26, 27}

The same arguments apply to an OACA, although to a somewhat lesser extent. Having a common regional anchor currency reduces transaction costs for all transactions within the bloc. The costs of collecting and processing exchange rate information become small as the exchange rate is (nearly) con-

²⁵ Mundell 1961, 509–517.

²⁶ Andrew Rose, "One Money One Market: Estimating the Effect of Common Currencies on Trade," *Economic Policy* 30 (2000): 9–48.

²⁷ Jeffrey Frankel and Andrew Rose, "An Estimate of the Effect of Common Currencies Unions on Trade and Income," *Quarterly Journal of Economics* 117 (2002): 437–466.

stant over time. As a result, regional transactions become cheaper and easier, thus increasing the volume of transactions.

Monetary efficiency gains

A single currency increases monetary efficiency by eliminating the price distortions that arise from transaction costs and lack of transparency. Another monetary efficiency gain relates to reducing the uncertainty linked to exchange rate movements.²⁸ Possible fluctuations in the exchange rate may hamper regional trade and investment. As a result of removing price distortions and exchange rate uncertainty, the region's economies benefit from stronger price signals, which results in improved resource allocation.

An OACA captures both aspects of the above-mentioned monetary efficiency gains. In line with a reduction of transaction costs, regional price distortions would drop. Businesses engaging in intra-regional trade and investment would face little uncertainty relating to exchange rate fluctuations (although the risk of abandoning the peg remains). To the extent that the countries in the region are important economic partners, their economies would experience better resource allocation and higher-factor productivity.

Anti-inflationary discipline

Another argument in favor of OCAs relates to the effects a common currency has on inflation.²⁹ Especially for countries with a history of high inflation, adopting a common currency is seen as a way to "import" monetary discipline.³⁰ Having a common currency means sharing the same monetary policy. As a result, a currency union helps reduce the costs of inflation.

For high-inflation countries, a peg often has the same function regarding monetary discipline as a currency union. Anchoring one's currency is a way to "import" monetary discipline and boost confidence in price stability. A regional anchor currency thus serves the same purpose and allows countries to reduce the cost of inflation. A possible constraint to a regional anchor bloc may be the lack of a regional anchor with a history of price stability.

Protection against destabilizing speculation

Adopting a common currency provides a powerful defense against destabilizing speculation.³¹ This defense is especially relevant for small countries, which are more vulnerable to speculative attacks. An anchor currency area, however, would still entail the risk of destabilizing speculation. A peg to a common anchor is a much weaker commitment to a certain exchange rate than actually giving up one's own currency. Contrary to the case of OCAs, the risk of destabilizing speculation is a significant downside of an OACA.

²⁸ Ricci 2008.

²⁹ Alesina and Barro 2002.

³⁰ Corden 2000.

³¹ Alesina and Barro 2002.

To address this risk, countries may impose capital controls in order to reduce international capital flows. Another conceivable instrument against speculation may be to establish a currency board in order to signal a strong commitment to the anchor.

Benefits from deeper regional economic integration

A common currency spurs regional economic integration by improving market access to other countries in the region. As a result, regional firms benefit from higher economies of scale. As unit costs fall, products become cheaper and firms become more competitive on global markets. In addition, increased intra-regional competition curbs monopoly power and further drives down consumer prices.

Similar to an OCA, a common anchor currency would be a significant step towards regional economic integration. Lower transaction costs and little exchange rate uncertainty would improve access to foreign markets. Similar benefits can be expected in terms of competitiveness and consumer prices. Yet while in the case of a single regional currency there are significant economies of scale in the development of financial markets (e.g., bond markets), this does not directly apply to OACAs. Nonetheless, a common anchor currency may boost confidence in local bonds and equities and thus contribute to the enhancement of financial markets.

Costs of OCAs and Application to OACAs

Economic stability loss: the costs of asymmetric shocks

The quintessential argument against monetary union is that its members have no independent monetary policy. This is because monetary policy needs to be used solely to support the peg to the regional anchor. As a result, the country forgoes the opportunity to use monetary policy for the purpose of stabilizing output, employment, and prices.³² Without an independent monetary policy, a country suffers greater macroeconomic instability. The loss of economic stability prevails under both an OCA arrangement and in an Optimum Anchor Currency Area. The extent to which countries in the region lose from having a one-size-fits-all monetary policy depends on the extent to which short-run adjustment is possible.

The literature on OCAs captures the debate on short-run adjustment under the concept of *asymmetric shocks*. A good example of an asymmetric shock is a sudden drop in the price of oil. For oil-exporting countries within the region, this shock would reduce the value of their exports and curb economic growth. The oil-exporting area would need expansionary policies designed to boost demand. However, such a monetary expansion may no longer be available as it would be unsuited to the needs of the region as a whole. In the event of an asymmetric shock, the exchange rate between two countries provides an effective instrument of economic adjustment. Changes

³² Ricci 2008.

in the exchange rate can help balance differences in economic growth, competitiveness, inflation, and other economic variables. Adopting a common currency or pegging to another currency is tantamount to eliminating this instrument of adjustment. As a result, adjustment takes place through alternative channels. In response to changing economic conditions, real variables such as output and employment may be adversely affected. Other channels for adjustment include *fiscal transfers* and *factor movements* between countries. Therefore, the desirability of a currency union is often assessed by considering how well fiscal transfers and factor mobility substitute for adjustment via exchange rates.³³

Fiscal transfers between sovereign countries are likely to be politically unviable, both in currency unions and especially in anchor currency blocs. The case of the European Monetary Union illustrates the difficulty of fiscal transfers. *Factor movements*, on the other hand, provide greater scope for economic adjustment. Yet, factors of production differ greatly in terms of their intra-regional mobility. Capital is usually the most mobile factor. International capital mobility provides a powerful means of adjustment by flowing to the region with the highest expected return, given a certain level of risk. Intra-regional labor mobility, however, is a less effective and politically controversial form of adjustment.³⁴

ASSESSING A PRACTICAL EXAMPLE OF A POTENTIAL OACA: SOUTH AMERICA

While the OACA model could be applied to a number of regions in the world, it is particularly relevant for those groupings that have already undertaken efforts towards regional integration. Prominent examples include the countries of the Association of South-East Asian Nations (ASEAN), the South Asian Association for Regional Cooperation (SAARC), the Gulf Cooperation Council (GCC), and the South African Customs Union (SACU). In order to analyze the practical viability and the implications of a regional anchor bloc, this section explores the scenario of an OACA in the region of South America.³⁵

South America provides an instructive example for an analysis of regional monetary integration. There is an ongoing debate among academics and policymakers as to whether South American countries, or a subset of these, would benefit from a monetary union.³⁶ The answer to this question has usually been negative, pointing to relatively low regional economic integration and lack of political viability.

³³ Mundell 1961, 509–517.

³⁴ Ricci 2008.

³⁵ In this analysis, the region of interest is South America rather than Latin America. This is because under the OACA approach, some Latin American countries such as Mexico are more closely integrated with the U.S. economy rather than with South American countries.

³⁶ Eichengreen 1998.

Often considered as the “backyard” of the United States, South American countries have a long tradition of aligning their exchange rate regimes with the dollar. Today, Ecuador and is dollarized, and Venezuela maintains an official peg to the dollar. There is, therefore, some support for the idea that the dollar might be “oversubscribed” in the region (as explained in section 2.3). At the same time, other countries including Argentina, Brazil, and Colombia have adopted inflation-targeting policies and have shifted towards flexible exchange rate regimes.³⁷ By itself, this is unfavorable to economic and financial integration because it tends to increase bilateral exchange rate volatility. However, as Allegret and Sand-Zantman argue, this is likely a transitory process that will ultimately induce South American countries to strengthen macroeconomic policy coordination.

Brazil’s presence as a regional hegemon has catalyzed some progress in regional economic integration in the last 15 years. The country’s continued leadership on regional issues has been accompanied with some calls for greater monetary policy coordination in the region.³⁸ Since the introduction of its new currency, the *real*, in 1994, inflation in Brazil has been brought down to an average of 4–5 percent. The real appreciation of the *real* before and after the global financial crisis has caused concern about the country’s export competitiveness and raised doubts about the sensibility of the current floating regime. As Eichengreen argued, Brazil might be more comfortable about floating its currency vis-à-vis the rest of the world with a regional exchange rate regime in place.³⁹ As a result, Brazil’s currency might be a good candidate for a regional anchor currency.

The trade network externalities argument applies well to the South American case. A number of Regional Trade Agreements have been concluded in recent years, spurring regional economic integration.⁴⁰ These agreements include the Andean Community of Nations (CAN) and the deepening of the Southern Common Market (Mercosur). The trend towards intra-regional trade gives rise to the conclusion that increasing trade-network externalities would at some point favor a regional monetary arrangement over a dollar anchor. Over the last decade, there has been a significant decline in the share of trade with the U.S., while the share of intra-regional trade has increased. To provide an indicator of this trend, Figure 3 shows the shares of U.S. and intra-regional exports of Brazil. In 2006, the intra-regional exports for the first time surpassed those to the U.S.

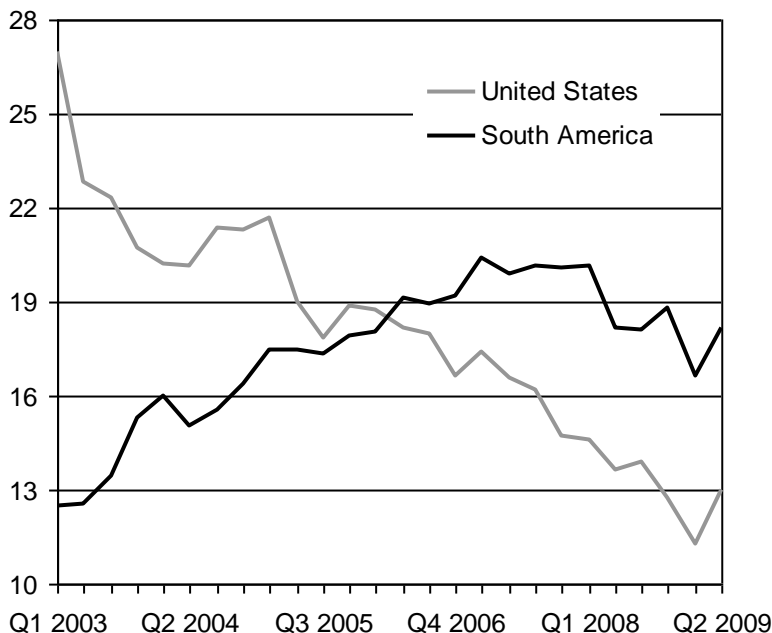
³⁷ Jean-Pierre Allegret and Alain Sand-Zantman, “Does a Monetary Union protect against foreign shocks? An assessment of Latin American integration using a Bayesian VAR,” *Journal of Policy Modeling* (2009): 102–118.

³⁸ Fabio Giambiagi, “Uma proposta de unificação monetária dos países do Mercosul,” *Revista de Economia Política* 17 (1998): 5–30.

³⁹ Eichengreen 1998.

⁴⁰ E. Dorrucchi, S. Firpo, M. Fratzscher, and F.P. Mongelli, “European Integration: What Lessons for Other Regions? The Case of Latin America.” Frankfurt am Main: European Central Bank, Working Paper Series No. 185, October 2002.

Figure 3: Brazil - Exports to the U.S. and to South America⁴¹
(in percent of total exports)



In practice, Latin American regional integration has often been hampered by political tensions and historically strained relationships. Although there is a general will for regional integration, these political tensions have often hindered significant progress on macroeconomic issues. It is therefore unlikely that the establishment of a monetary union is a viable policy option in the near future.⁴² A regional anchor bloc would be a politically more palatable alternative because it entails only a partial sacrifice of monetary autonomy. In addition, the symbolic value of the countries' national currencies would be preserved. While most scholars deem monetary union to be unattainable in the foreseeable future, establishing a regional anchor bloc is a much more viable option.⁴³

The trend towards increasing regional trade network externalities, the political impediments to monetary union, and the availability of a potential anchor currency suggest that the OACA theory could be applicable to the case of South America. Given the economic benefits and the political viability

⁴¹ Author's own illustration based on IMF Direction of Trade Statistics (DOTS) figures, which are available from the IMF at <http://www.imfstatistics.org/dot/>.

⁴² Ibid.

⁴³ Giambiagi 1998, 5-30.

ty of a regional anchor bloc, this arrangement may constitute a superior regime for the region.

CONCLUSION

The purpose of this paper was to set out the rationale for Optimum Anchor Currency Areas. The case for OACAs is based on the empirical finding that trade network externalities heavily influence anchor currency choices. The trend towards regionalization of international trade in the past two decades supports the case for OACAs. Given expanding shares of intra-regional trade volumes, countries may benefit from pegging to a regional anchor, even when monetary union may not be viable. A regional anchor bloc would be easier to achieve politically, as it implies less intrusion into matters of national sovereignty. The paper discussed the various costs and benefits that would arise from a regional anchor bloc compared to those of monetary union. While many of the benefits of OCAs also apply to OACAs, the latter also have significant downsides. In particular, the risks related to abandoning the peg remain. These risks may be somewhat alleviated by the flexibility in the design of a regional anchor bloc. Finally, the case of South America illustrated a concrete example of the implications of a regional anchor bloc. It provides some empirical support for increasing trade network externalities and sets out the political advantages of pursuing an OACA.

Although exchange rate regimes have not experienced drastic changes in recent years, this may change in the near future. A potential demise of the dollar raises doubts as to the stability of the international monetary system. History shows that an unraveling of the dollar would not be all that exceptional. The demise of the Dutch guilder, the classical gold standard, and the pound sterling all suggest that such a reappraisal of international exchange rate regime choices is a real possibility. In this event, regional anchor blocs may indeed be a politically viable and economically superior configuration of the international monetary system.