Reply to Jeffry Frieden and to the second referee

I really appreciate the comments by prof. Jeffry Friden and the second referee. I agree with the former on writing a more elaborate cost-benefit analysis, in order to make clearer why my suggested monetary system can address the inefficiencies of the current one. In the paper, I pointed out the main points, but a clearer and more comprehensive analysis is required.

On the political feasibility, some considerations could improve the proposal. However, the political feasibility depends on the quality of the proposal and cannot be defined *ex ante*. Of course, one can imagine some degree of feasibility but nothing more.

On the second referee's comments I agree on some points, but I tend to disagree with his main critique about the practicability of the proposal. Fifty years ago no one would have imagined the creation of a unified European currency. Even before its creation, there were many concerns about its desirability. Today, we can state that the Euro experience has been quite successful. Therefore, realism is not the right way to approach the issue; only efficient considerations matter. I shall know respond to the several points made by him:

- In my paper I explicitly said that figure 2 is not about causality but it shows a strong relation between oil prices and the US exchange rate. This basic empirical evidence seems to confirm the section about oil price movements. It is true that oil rich countries could be always tempted to increase oil prices. However, in order to survive on the market increasing prices requires coordination that can be easily achieved with floating exchange rates, that imperil the profits of all oil exporters. A stable fixed exchange rate between OECD countries and oil exporters would drastically reduce the incentive to cooperate. The idea is the following. Fixed exchange rates, by definition, do not change the real value of oil profits; therefore, for oil exporters there would be less incentives to cooperate aiming at increasing prices.

- In the post war era, many developing countries have proved their inability in adopting credible and wise monetary policies, often leading to currency crises. Usually these crises were due to a *time inconsistency* problem or a lack *credibility* from the policy makers. An independent and sovereign central bank that is in charge of keeping inflation close to a certain target could solve these issues. In this case, national governments will not be able to adopt inflationary policies by themselves. Thus, foreign investors are induced to lend money in the new currency because of its consolidated credibility, avoiding balance sheet mismatches and creating a more integrated financial market. Moreover, the other costs due to dollarization would be avoided, since seignorage could be proportionally distributed between the members of the union, the exchange rate could still serve as a shock absorber, and the sovereign central bank could act as lender of last resort. Therefore, if it is possible to find countries whose economies are highly integrated according to the OCA criteria, then a credible regional monetary authority would generate a more efficient system, compared to the case of dollarization.

- As the current financial crisis showed, advanced economies are exposed to the same main shocks. Caballero (2009) has recently stated that an excessive demand for American safe financial assets increased the systemic risk. To solve the issue, he suggested to create an insurance scheme. My proposal aims at getting the same result in a different way. Creating a common currency among OECD countries could increase the degree of international risk sharing. The idea is the following: Asian economies over-invested in the US in order to keep undervalued their exchange rate against the dollar (Roubini and Saetser, 2005). They have used that strategy since the US are their main trade partners. If there had been a common currency among safe asset producers -e.g. OECD countries-, Asian economies could have invested in countries different from the US without loosing international competitiveness. In this way their investments would have been more differentiated and the risk sharing would have been higher, avoiding to generate safe assets from unsafe ones, as Caballero (2009) pointed out.

- Figure 4 shows that, apart from Japan, all the monetary decisions are undertaken by the US and then followed by other countries.

In general, I think that both comments can improve my proposal. If I have the opportunity, I would like to rewrite part of the paper keeping in mind all their suggestions.

Reference

Caballero, Ricardo (2009). "*The Paolo Baffi Lecture*", delivered at the Bank of Italy on December 10th.

Roubini and Saetser (2005), *"Will the Bretton Wood II regime unravel Soon? The risk of a Ahrd Landing in 2005-2006*", NYU Working Apaper