

## **Referee's report on L. Ricci, 'A model of an optimum currency area'**

This paper sets out to construct a comprehensive model in which the costs and benefits of currency union can be analysed, including nominal rigidities, monetary and real shocks, and transactions costs. The model has some attractive features – notably the explicit treatment of transactions costs and the inclusion of inflation costs in assessing welfare, and it is largely successful in incorporating the key elements of the optimum currency area literature in a single model. The results are generally in line with the standard literature, with the exception of the finding that greater openness does not necessarily favour currency union.

Inevitably, however, the success of the model depends on some simplifying assumptions which somewhat detract from the conclusions. First, the model contains only two countries, home and foreign, which make or do not make a currency union between them. Much of the OCA literature has been developed in this context, so in that sense this paper cannot be faulted, but it should be obvious that it makes it difficult to relate the model to the choices that countries really face, where joining a currency union changes a country's exchange rate regime with both the existing members of the union and the existing non-members. The importance of the latter effects is made clear by the author's own speculative comments on the choices for CIS or Middle East countries in his final paragraph.

Second, the model has no role for capital flows and the exchange rate is determined by the trade flows. This aspect of the model skews the findings in several ways which are not helpful. On the one hand, it means that demand shocks to tradables are completely neutralised in the non-currency union (flexible exchange rate) case, which both biases the comparison in favour of flexible rates and contributes to the anomalous finding on openness (such shocks have effects only in the currency union case). On the other hand, it also eliminates what are sometimes referred to as 'international risk-sharing shocks' (or UIP shocks) in the flexible rates case, which again biases the results in favour of flexible rates.

In addition, the model contains no supply shocks, no long run (e.g. PPP), no pass-through from the exchange rate to prices, and so on.

It would obviously be difficult to incorporate these features into the model, which is already relatively complex. But it would be useful if the author could spell out more clearly the simplifications he has made, and speculate on their consequences for his results.