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'The Theory of Optimum Financial Areas: Retooling the debate on the governance of global finance'

Abstract:

This article examines the institutional preconditions for stable financial integration in a 'theory of optimal financial areas' (OFA). This theory is modelled on the theory of optimal currency areas that has been used to inform the process of monetary integration. Where it differs from optimum currency area (OCA) theory is in focussing on capital mobility and cross-border financial transactions rather than concentrating on exchange rates or macroeconomic adjustment. We contend that OCA theory misdirects both the analysis and the policy response: it is more pertinent to ask what makes for financial stability under conditions of market integration than what makes for stable currencies and smooth macroeconomic adjustment. The article proposes six 'criteria' that should be met in order to stabilize an integrated financial 'market geography'. Three of these criteria relate to the technical substructure of markets, and include a shared risk free asset, centralized sovereign debt management, and common market infrastructures for communication, clearing, settlement and depository. Three further criteria focus on the macro-prudential considerations like shared rules for financial supervision, centralized lender of last resort facilities for private- and public-sector market participants, and common provision for the resolution of failed private- and public-sector borrowers. These criteria are controversial both individually and as an interdependent package. Nevertheless, they are important to mitigate the costly dynamics of financial market disintegration under crisis conditions. We use case studies of the Great Britain, the United States and Canada to show how national governments have stumbled toward a similar set of arrangements to stabilize domestic financial market integration. The more recent experience of the European Union shows this pattern applies across countries as well. We conclude with a research agenda based on these considerations.