

Optimal Currency Areas An Academic View

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Mundell (1961)

The stabilization argument

- “The argument for flexible exchange rates based on national currencies is only as valid as the Ricardian assumption about factor mobility.”
- What is the optimum currency area, i.e. the area where there is both internal factor mobility and external factor immobility? The region, bigger or smaller than the nation.
- “Today, if the case for flexible exchange rates is a strong one, it is, in logic, a case for flexible exchange rates based on *regional* currencies, not national currencies. The optimum currency area is the region.”

A pragmatic approach

- “...whether or not Western Europe can be considered a single region [and therefore whether the Common Market should adopt a common currency] ...is essentially an empirical problem [about the degree of factor mobility].”
- But the degree of factor mobility should not be the only criterion to determine the optimum number of currencies
 - Money is a convenience => the OCA is the world: lower bound
 - Money illusion increases, and therefore the effectiveness of ER instrument decreases, when the size of currency areas decreases => the OCA cannot be too small: upper bound

Implicit OCA criteria

- The loss in terms of stabilization due to the creation of a common currency will be higher when
 - macroeconomic shocks are more asymmetric
 - ER instrument is more powerful for offsetting them. Also McKinnon (1963) about the role of country size.
 - other adjustment mechanisms (product and factor prices, and factor mobility) are less effective. Also Kenen (1969) about the existence of a common fiscal system.

Empirical evidence: the 1990s

- Asymmetric shocks
 - Bayoumi and Eichengreen (1993, 1996, 1997) and others: Core (Germany, France, Benelux, Austria, Denmark) vs. Periphery (Italy, Spain, Greece, Portugal, Ireland, Finland, UK, Sweden)
 - Forni and Reichlin (1997): however the core is not defined by a set of nations, but by regions belonging to different countries
 - Bini-Smaghi and Vori (1992) and Krugman (1993): EU countries are less specialized than US regions
- Labour mobility as an adjustment mechanism
 - Various papers based on Blanchard and Katz (1992) for the US

Maastricht criteria (1991)

No apparent link to OCA theory

- OCA criteria: real convergence, i.e. integration
- Maastricht criteria: nominal convergence

Why such apparent discrepancy?

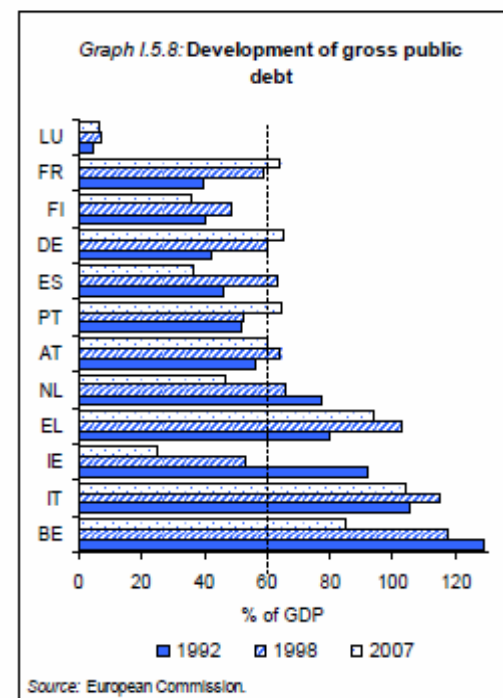
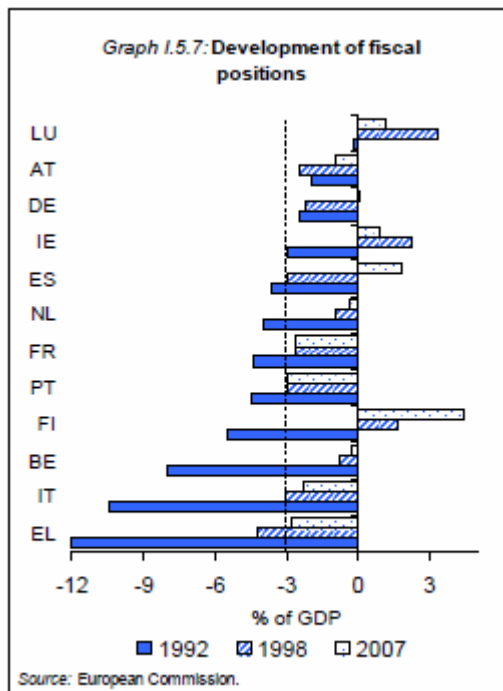
- Political explanation: EMU driven by political rather than economic considerations
- Economic explanation for disregarding OCA criteria:
 - Macroeconomic shocks will be reduced by EMU (less monetary errors) and less asymmetric (more intra-industry trade and less specialisation: Frankel and Rose (1998)'s endogeneity of OCA)
 - ER instrument has lost usefulness due to free capital movements
 - Other adjustment mechanisms (mostly fiscal) are working well
- But this does not explain why other criteria were used instead of OCA. Maastricht criteria: more about stable than common currency.

What if OCA had also been used?

- Only 'core' countries may have qualified initially
- What may have been the consequences of a narrow EMU?
Viñals (1996):
 - Unwanted currency depreciations => problems for Single Market
 - Higher interest risk premia => increased budget deficit
 - “It is now time to start developing transitional arrangements [to] enable a sufficiently wide EMU to be established...in a series of steps...At stake is not only the chance to create a monetary union that is adequately representative of Europe, but also the preservation of the integrity of the Single Market.”
- Was it a mistake to ignore OCA criteria?

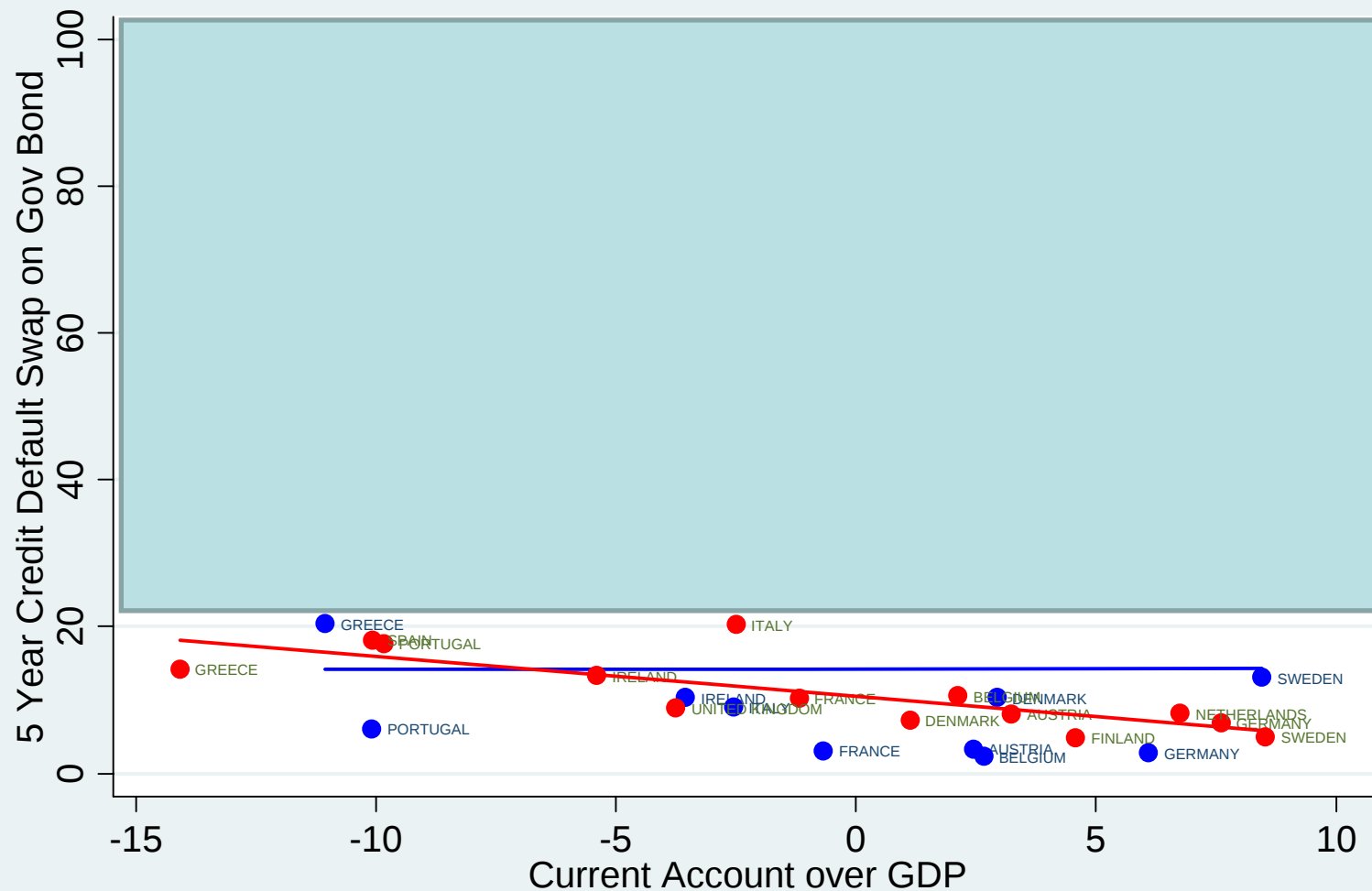
Wide EMU in good and bad times

- The SGP can be viewed as a bridge between OCA and Maastricht. Meant to ensure that fiscal adjustment works, especially in non-'core' countries, that needed it most.



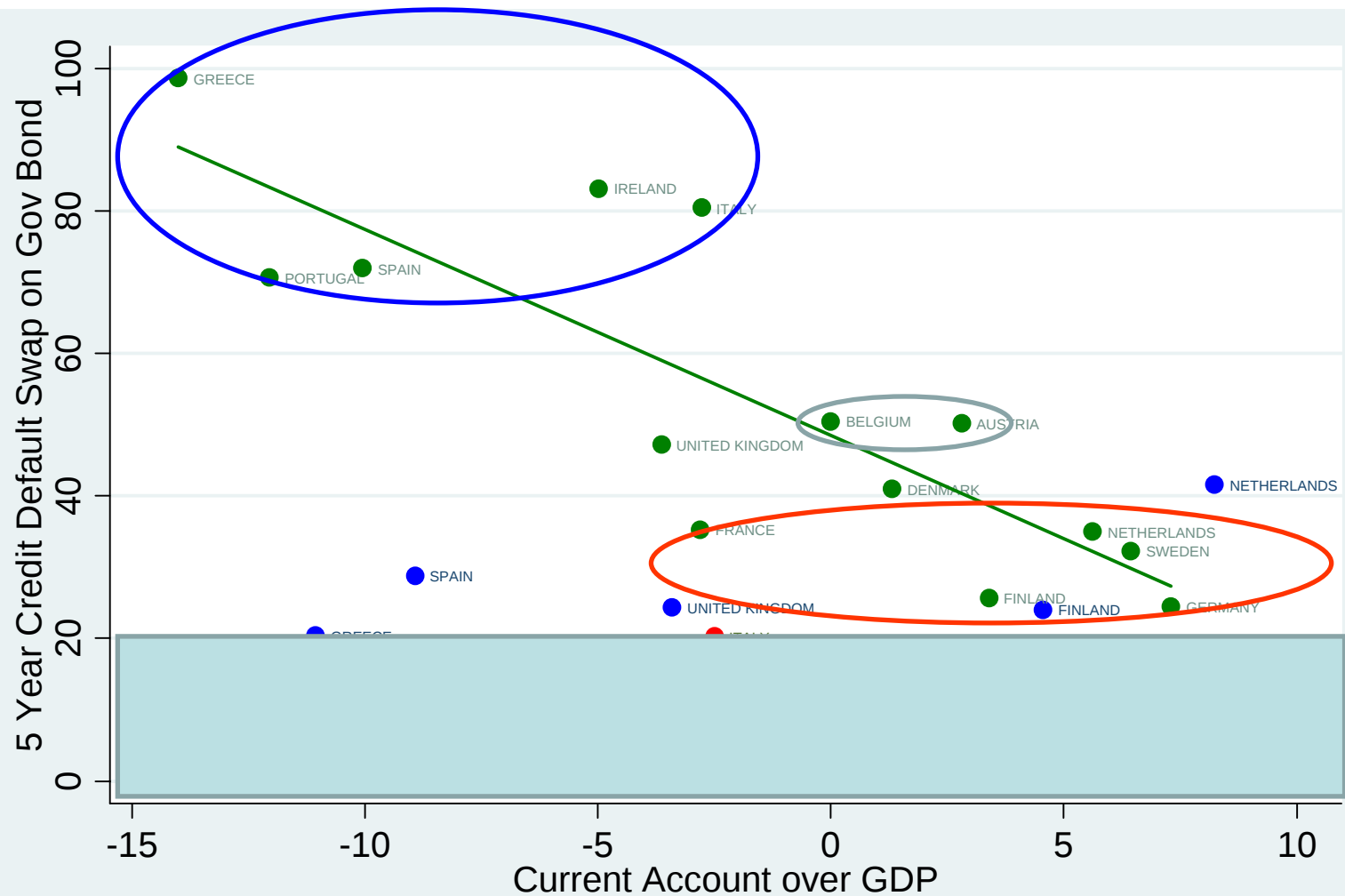
- Insufficient progress in some of these countries

Little effect during good times



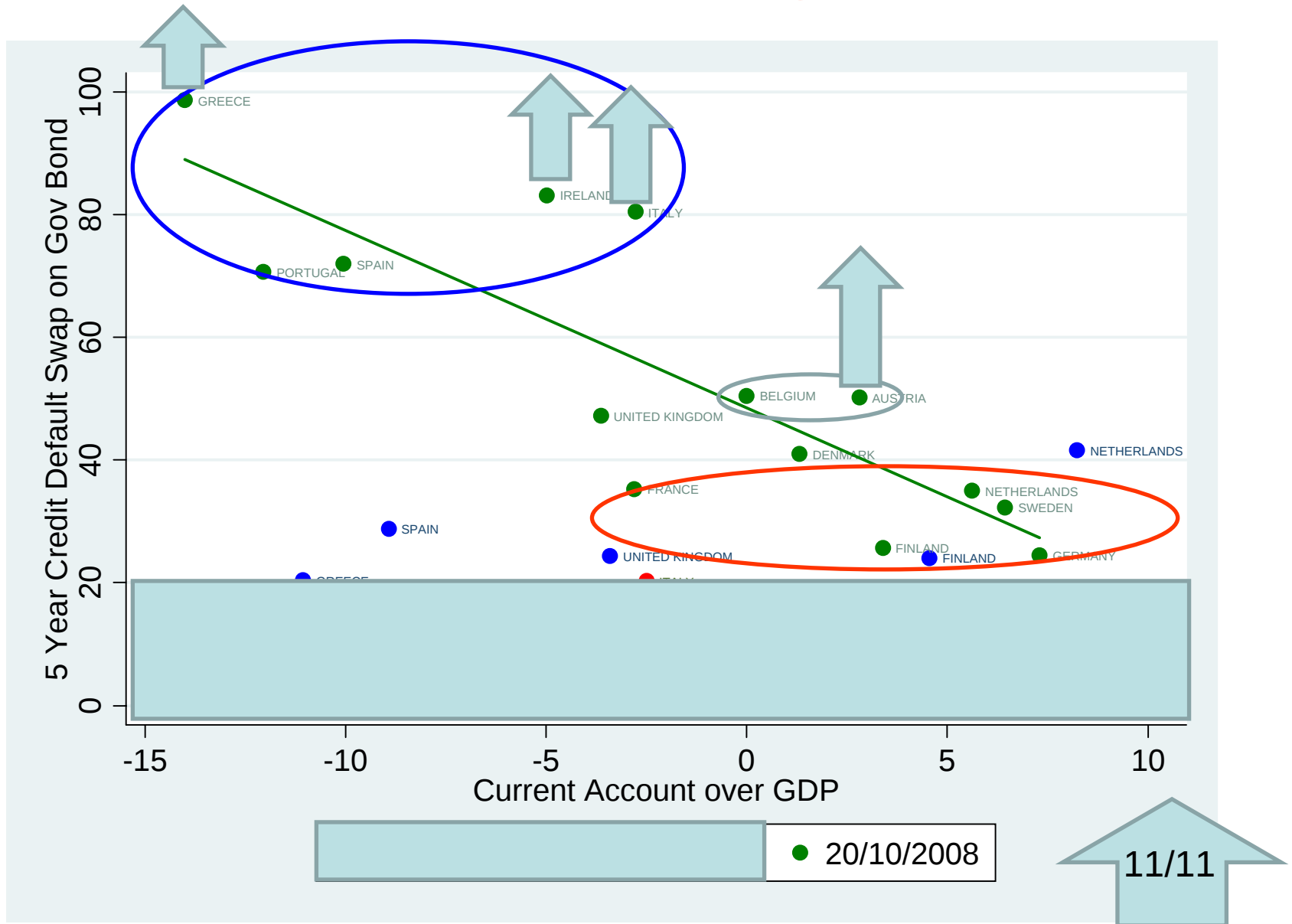
● 31/12/2006 ● 29/12/2007

More effect during bad times...



● 2010/2008

...and even more during worse times



Conclusion

- OCA criteria are relevant and important in principle
- But difficult to use in practice
 - Issue of countries vs. regions
 - Shocks before EMU may be a poor guide to shocks after EMU
- This implies that entry criteria are necessarily imperfect and that systemic surveillance after entry is crucial to avoid problems in bad times