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
More effect during bad times…
...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