EU Economics: Optimal Currency Area Theory

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Optimal Currency Areas

An important part of European integration is monetary integration. Within economics there is what is called the **optimal currency area** theory, which sets out to describe a set of favourable conditions which can help a region to adopt a single currency.

Benefits of a Common Currency Area

There are a number of economic benefits associated with having a common currency area, which include:

1. The lowering of transaction costs
   - There is no need to worry about the currency of the transaction or the exchange rates
   - Which entails that there is no loss of value in transaction
   - And as such it might lead to increases in competition
2. Price transparency
   - Prices are directly comparable across different regions within the currency area
   - Again this might lead to increases competition which is good for consumers
   - Due to reduction of border-effect, it can open up trade opportunities
   - Price transparency and the associated increases in competition will also have effects on wage setting
3. Reduction in uncertainty
   - Removing the risk resulting from exchange range regime will be beneficial to the levels of foreign direct investment
4. Improvements concerning trade
   - Payments will be easier and more secure in an area that shares a currency, which will again lead to increases in competition
   - A common currency can also help reduce non-tariff barriers, such as reducing the monopoly power of certain firms in particular regions

5. Quality of monetary policy

   - Improvements in the quality of monetary policy of course depends on the quality of the central bank
   - The idea is that regions which has lower quality levels will be leveled up to a higher level with a central bank doing a better job in implementing policy
   - It does involve a certain loss of national monetary policy autonomy though

This is an important caveat as the eurocrisis has recently shown.

Costs of a Common Currency Area

NATURALLY, THERE ALSO SOME COSTS ASSOCIATED WITH HAVING A SINGLE CURRENCY, which come mainly from cross-regional difference on a number of issues. One particular concern is the manner in which a region reacts to a shock. Let's examine some of the limitations associated with a single currency area.

Shocks can include everything here, from macroeconomic shocks such as a global recession to more local phenomena such as an earthquake.

- Link between shocks and the exchange rate
  - A country experiencing a shock can't lower prices to increase competitiveness
  - And there are no alternatives either
  - As a result, it is likely that the economy will slow down for a prolonged time

This happened to Germany at the turn of the century and the country was famously dubbed the sick man of Europe. Things look quite different now from a German as well as European perspective.

- Asymmetric shocks
  - Since countries have different characteristics, they will face different type of shocks
  - In a currency union the setting of the exchange rate will affect both countries
  - When one country experiences a shock the central bank has to make a decision. But this decision will likely have diverging effects across countries. The common exchange rate cannot insulate all countries.

Think about the refugee influx in Italy and Greece which are closer to Africa and the Middle East.

- Symmetric shocks with asymmetric effects
- Countries can experience the same shock, but react differently
- This can be the result of the country's socio-economic structure such as labour market regulations, the relative importance of certain sectors, such as the financial industry, external debt etc.

Think for instance about the fall out of Brexit for the other EU member states. Countries that have close economic ties to the U.K. like Ireland and Denmark are much more exposed compared to for instance Portugal and Slovenia.

Criteria for a Common Currency Area

THE TERM OPTIMAL IN OCA IS A BIT MISPLACED. The theory brings together the costs and benefits of sharing a currency but doesn't really discuss anything related to optimal conditions. Additionally, the theory doesn't even discuss which type of countries should for a currency union. It only provides a set of criteria which make a currency union acceptable. There are three economic and three political criteria.

These criteria are based mainly on the work by Mundell and Kenen.
Also note that the criteria are largely endougenous as they might change over time.

1. Labour mobility
   - In an OCA the people should be able to move easily
   - This also in order to deal with shocks which can be more easily mitigated when the factors of production, such as labour are able to move freely within the OCA
   - Note that various barriers to migration continue to exists such as cultural factors like a different language, or the skill of the migrant labourer

Other factors of production such as large machinery are less easy to move across countries.

2. Production diversification
   - Having a similar production structure and widely diversified production and exports is beneficial for a OCA
   - Recall that asymmetric shocks are a large problem for currency areas. Question is how often do these shocks occur
   - If rare, the costs are just episodic while benefits will accrue every day.
   - Countries that will be affected the most by these severe shocks will be those with a specialised economy
   - Therefore, when the countries in an OCA all have a diversified economy, producing similar goods, this will reduce the probability of asymmetric shocks

Think the reliance of Greece on a few key industries.

This is a very broad statement though as it is not entirely clear how diversified economies should be to reach this desired immunity.

3. Openness
   - Countries can form an OCA when they are very open to trade and trade heavily with each other
   - In this scenario the distinction between domestic and foreign goods is lost as competition will equalise prices of most goods, when expressed in the same currency

Changes in the exchange rate might affect competitiveness through exports; firms might want to focus on exports at certain price levels as it is more profitable.

4. Fiscal transfers
   - When countries agree to compensate each other for adverse shocks, they form an OCA

- There is a moral hazard issue here
  - Certain countries might be expecting these transfers to happen, meaning that they can be slacking
  - For instance, their economy might not be diversified enough, they are too dependent on imports, or have too rigid labour markets which make adjustments long and painful

This has been an important discourse in the eurocrisis where Northern eurozone countries blame Southern eurozone countries for having lacked in fiscal discipline for instance during book periods.

5. Homogeneous preferences
   - Currency union member countries must reach consensus on the best way to deal with shocks
6. Solidarity vs. nationalism
   - When the common monetary policy gives rise to conflicts of national interests, the countries that form a currency area need to accept the costs in the name of a common destiny
   - This involves costs, but these are accepted as long as they are lower than the cumulative benefits
   - This criteria also implies that there should be a move to a political union