A new optimum currency area index for the euro area

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Abstract

We propose a new and time-varying optimum currency area (OCA) index for the euro area in assessing the evolution of the OCA properties of the monetary union from an international business cycle perspective. It is derived from the relative importance of symmetric vs. asymmetric shocks that result from a sign and zero restricted open-economy structural vector autoregression (VAR) model. We argue that the euro area is more appropriate through the lens of empirical OCA properties when the relative importance of common symmetric shocks is high, but, at the same time, is not overly dispersed across euro area member countries. We find that symmetric shocks have been the dominant drivers of business cycles across euro area countries. Our OCA index, nevertheless, shows that cyclical convergence among euro area members is not a steady process as it tends to be disrupted by crises, especially those not primarily triggered by common external shocks. In the aftermath of a crisis the OCA index embarks on a recovery trajectory catching up with its pre-crisis level. Our OCA index is slow-moving and a good reflection of changing underlying economic structures across the euro area and, therefore, informative about the ability of monetary policy to stabilise the euro area economy in the medium run.

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