Chapter 11
Optimum Currency Areas

Overview

• One money or many?
• 6 criteria of an optimum currency area (OCA)
• Is Europe OCA?
• Will it become one?

Introduction

• Does the world need more than one currency?
  – Who decides?
  – Many theories – and people change minds (e.g. Mundell now advocates single gold-based currency)
• Benefits of single money
  – Lower transaction costs \(\Rightarrow\) easier to trade
  – More certainty
  – Less international instability
• Costs and obstacles
  – Paper money \(\Rightarrow\) who controls?
  – Hard money \(\Rightarrow\) short-term problem of sticky prices & wages?

OCA theory

• Asymmetric shocks \(\Rightarrow\) how to deal with it?
  – Sticky wages & prices: don’t adjust quickly
  – E.g. Unemployment in country A, not in country B
    – A’s interest: depreciate currency \(\Rightarrow\) boost export industries
    – B’s interest: stable money, low inflation
  – Benefits of a single currency
    – Different currencies – different policies
    – Same currency – compromise!

Six OCA criteria

• Three classic (economic) criteria
  – Mundell: labour mobility
  – Kenen: product diversification
  – McKinnon: openness
• Three political criteria
  – Fiscal transfers
  – Similar preferences/ideologies
  – Solidarity / ‘Commonality of destiny’

Criterion 1: Labour mobility

• OCA: Labour moves easily across borders
  – Reason: unemployment in one region \(\Rightarrow\) people move to another region
  – USA: very high mobility
  – EU: not so (Chapter 8)
Criterion 2: Production Diversification
- OCA: regions/countries whose production and exports are widely diversified and of similar structure
- Reason:
  1. There will be less macroeconomic shocks
  2. They will be more symmetric → no conflict
- Africa: countries very specialized → vulnerable to severe shocks

Criterion 3: Openness
- OCA: regions/countries that are very open to trade and trade heavily with each other
- Reason: goods prices adjust more quickly, so macroeconomic shocks don’t require so much intervention

Criterion 4: Fiscal Transfers
- OCA: regions/countries that agree to compensate each other for adverse shock
- Reason: costs of asymmetric shocks are not so high
- Transfers exist within national borders:
  - Implicitly through the welfare system (crisis areas pay less tax and receive more welfare benefits)
  - Explicitly in federal states

Criterion 5: Homogeneous Preferences
- OCA: regions/countries that share a wide consensus on the way to deal with shocks
- Reason: otherwise strong political conflicts (Unemployment? Inflation? Welfare payments?)
- Depends on:
  - Institutions
  - Ideologies

Criterion 6: Commonality of Destiny
- OCA: countries that view themselves as sharing a common destiny
- Reason: better accept temporary conflicts of interests
- E.g. USA: mostly very strong

Is Europe An OCA?
- 1. Labor mobility: quite low (people move little)
  - Languages, different welfare systems, pension systems, cultures, family, national attachment
  - E.g. Spanish unemployment vs. Finnish unemployment
- 2. Diversification and similarity: quite high
  - Product diversification: high
  - Similarity of structure: depends
- 3. Openness: quite high
- 4. Fiscal transfer: no
- 5. Homogeneity of ideologies: mixed
  - Monetary history: low inflation Germany vs. High inflation Italy...
- 6. Commonality of destiny: mixed
  - Some common histories, but also wars and conflicts
Will monetary union create an OCA?
- Mutual trade: support
- Diversification: tendency to specialize
- Labour markets: common labour laws?
- Fiscal transfers: EU tax + unemployment benefits?
- Solidarity: ??

**Future**

**Summary**
- Why have many national currencies?
- Asymmetric shocks and sticky prices/wages
- Criteria of a optimum currency area (OCA)
  - Labour mobility
  - Product diversification
  - Openness
  - Fiscal transfers
  - Similar ideologies
  - Solidarity
- Europe is not really an OCA – but common currency forces deeper integration

**OCA & politics**
- EMU: negotiations were not based on OCA theory
- Martin Feldstein (Harvard): common currency = conflict
  - “Political leaders in Europe seem to be prepared to ignore these adverse consequences because they see EMU as a way of furthering the political agenda of a federalist European political union...”
- Survival of EMU requires a more federal EU
  - Pressure to harmonize tax laws, labour markets, welfare systems...

**Future**

**Summary**
- Why have many national currencies?
- Asymmetric shocks and sticky prices/wages
- Criteria of a optimum currency area (OCA)
  - Labour mobility
  - Product diversification
  - Openness
  - Fiscal transfers
  - Similar ideologies
  - Solidarity
- Europe is not really an OCA – but common currency forces deeper integration