

Ευρωπαϊκή Οικονομική Πολιτική

Δρ Ευάγγελος Διοικητόπουλος

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Outline of the Presentation

- Main Topic: **Optimum Currency Areas**
- Analyzing the Benefits of a Currency Area
- Analyzing the Cost of a Currency Area
- Examine whether Europe is an Optimum Currency Area

Main Question

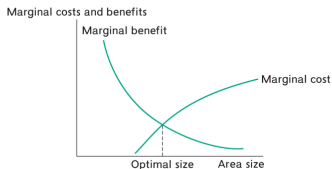
- Does it worth to join a currency Union?
- How many countries shall we allow to enter?
- What are the conditions such that a currency Union to provide benefits for all?

Quick Answer

- Money makes transactions immensely easier: the more people accept a currency, the more useful it is;
- as a currency area grows larger, it becomes more diverse, which means more costly.
- The solution has to involve trading off these costs and benefits (at the margin):

Quick Answer

Figure 15.2 The logic of the optimum currency area theory



Benefits

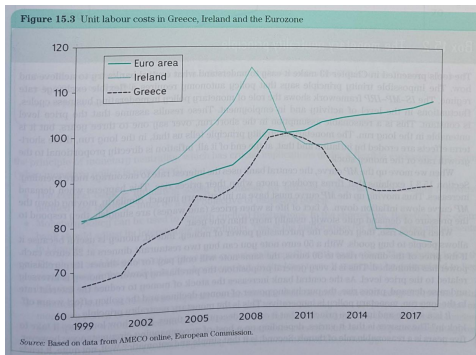
- **Elimination of transaction costs:**
 - If you started with one EU currency and exchanged it successively in all the currencies of the EU (before the Euro) and then exchanged it back into the initial currency, you would get less than 50% of the initial amount!

Benefits

- **Price transparency:**
 - Prices become directly comparable across countries and intensified competition;
 - transparency and competition also affect wage-setting.

Benefits

• Price transparency:



Benefits

- **Price transparency:**
 - Elimination of exchange rate risk (for trade transactions and FDI) = less uncertainty.

Benefits

- **Intensified trade:**

- Common currency eliminates a number of non-tariff barriers.

Benefits

- **Quality of monetary policy**
 - More independent central bank and better quality of monetary policy.

Cost

- **Loss of Monetary Policy**
 - Remind the sustainability-credibility trade-off we discussed in the previous lecture.

Cost

- **Diversity (Assymmetric Shocks)**
 - Diversity in a currency area is costly because a common currency makes it impossible to react to each and every local particularity.

Optimum Currency Areas

- The optimum currency area (OCA) theory brings together the benefits and the costs to derive practical criteria to understand which countries should share the same currency.
- It derives criteria that make a common currency acceptable, not optimal (!); and the criteria are never black or white, they are more or less fulfilled.

Optimum Currency Areas

- Three classic (economic) criteria:
 - Labour mobility (Mundell): Since prices and wages are sticky, one solution is for production facilities to move from the country that faces an adverse shock to the unaffected countries. Equipment is relatively easy to move, but what about people?
 - Diversification (Kenen): Strong asymmetric shocks are bound to be rare if all countries produce a wide and similar range of goods.
 - Openness (McKinnon): Goods prices in countries that are very open to trade cannot be rigid.

Optimum Currency Areas

- Three criteria with more political flavour: :
 - **(Fiscal) transfers:** Shocks are avoidable but their occurrence is a near-certainty. Are there insurance mechanisms that mitigate, or even eliminate, their consequences?
 - **Homogeneous preferences:** Even in the presence of symmetric shocks, countries may disagree on the remedy. In the opposite, like-minded countries can promptly agree on policy responses.
 - **Degree of solidarity:** When one country suffers from a serious shock and cannot respond with an exchange rate change, it often is in the collective interest for the other members to rescue it in various ways.

Optimum Currency Areas

- Evaluation of Criteria in Europe
 - **Labour mobility: Europeans move little!**
 - **Diversification and trade dissimilarity = trade dissimilarity index:** hi diversification for some countries.
 - **Openness = openness to trade:** Group of countries

trade dissimilarity index

Figure 15.12 Trade dissimilarity index



Note: The index measures the difference between individual countries' trade structures and those of their partners.

Source: Based on data from Horváth (2007).

trade dissimilarity index

Figure 15.13 Openness to trade, 2018



Note: The index is the ratio of the sum of exports and imports to GDP. It may exceed 200% as some imports are re-exported and therefore double-counted. Luxembourg (43%) and Malta (24%) are excluded.

Source: Based on data from AMECO, European Commission.

Fiscal Transfers

- **Fiscal transfers:**

- up until the debt crisis, there was no transfer system in the EU;
- EU budget is small (slightly above 1% of GDP) and almost entirely spent on operating expenses, CAP, and Structural Funds;
- crisis led to the creation of the European Financial Stability Fund (EFSF), transformed into the European Stability Mechanism (ESM).

Homogeneous Preferences

- **Homogeneous preferences:**
 - based on past inflation rates, it does not seem that country share similar views on monetary policy;
 - similar story when looking at public debts;
 - there remains some heterogeneity among national preferences.

Is Europe an optimum currency area?

So, is Europe an optimum currency area? Mixed performance:

Table 15.1 OCA scorecard

Criterion	Satisfied?
Labour mobility	No
Trade openness	Yes
Product diversification	Yes
Fiscal transfers	No
Homogeneity of preferences	Partly
Commonality of destiny	?

- The OCA criteria themselves are not clear-cut. They are unlikely to be entirely satisfied or entirely violated.
- Ultimately, the economic case is undecided, and the decision to create the monetary union must rest on political considerations.
- The crisis reminds that asymmetric shocks do happen and that they can be painful.

Is Europe becoming an optimum currency area?

The degree of fulfilment of the six OCA criteria is not a given, it may change over time.

- This possibility is called the endogeneity of the OCA criteria:
 - effects on labour markets and mobility;
 - effects on trade and specialization;
 - fiscal transfers.
 - Politics: preferences and common destiny.

Political considerations have been paramount in launching the euro; political leaders agreed on the monetary union without thinking in terms of the OCA theory. They were largely focusing on the symbolic nature of the undertaking. Their intention was to move one step further in the direction of an 'ever-closer union'.