Revenge of the Optimum Currency Area

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Optimum Currency Area theory

This theory was developed by R. Mundell in 1961, which explains the vantages and disadvantages of a monetary union.

However with the creation of the European Monetary Union (EMU) this theory has not been considered.

Actually this can be considered the starting point of all Euro's problems.

OCA: Advantages of a common Currency

- reduction of transaction costs;
- elimination of currency risk;
- greater transparency of prices;
- greater competition among firms;
- increase of trade among countries of the same currency area;
- financial stability (it's easier to face bank crisis);
- control of inflation.

OCA: disadvantages of a common currency area

- loss of flexibility;
- loss of national monetary policy;

  Changes in relative prices and wages are much more easly and quickly made via currency depreciation than by renegotiating individual contracts.

- asymmetric shocks;

  When countries under a monetary union react in different ways in front of an economic event.

However we have to consider that it is impossible to quantify all costs and benefits of a monetary union.

How mitigate costs arising from Asymmetric Shocks

We have to follow two main points:

The first one has been argued by Mundel, who said that a single currency works better if there is an high factor mobility between countries.

The second one has been supported by Kenen who said that asymmetric shocks can be faced with a large fiscal integration.

Some examples:

1) Regarding **fiscal integration**, Florida after the recent housing bust, needed more social help than the other states. This event created an asymmetric shock solved by federal tranfers.

This did not affected the national budget thanks to the payment of federal taxes.

2) Regarding **factor mobility**, Massachusetts, by the mid 90s, reduced the unemployment rate thanks to labor emigration in neighboring states.

Nonetheless Europe is caracterised by limited labour mobility and virtually no fiscal integration.

Why did policy makers belive that EMU would work?

Assuming that asymmetric shocks would be a relatively minor problem,

European leaders thought that they could achieve a degree of wage flexibility that would be more or less unprecedented in the modern world.

But they do not considered that, for example, syndicates of workers are characterised by different level of centralisation.

After the creation of european common currency

Many investors percepted that risks associated with cross-border investments within Europe had been eliminated.

As a consequence there was a massive capital movement from Europe's core (Germany and Netherlands) to its periphery (Spain, Greece...).

Thus has distorted the economic growth of periferical countries.

This movement was itself a large asymmetric shock

Banking issues

Traditional OCA theory paid little attention to bank integration.

Comparing Fed with ECB, we can observe that Us banks are backed by the Central Bank, while european banks are regulated and insured by national central banks.

In fact banks crisis are solved by sovereign debt.

This banking structure create the so called "**Doom loops**" phenomenon.

Doom Loops

This phenomenon happen when a bank crisis force States to refund insolvent banks - increasing Sovereign debt- in turn banks, to avoid the States bankruptcy, buy Treasury Bills.

Thus the solution of this problem can be an higher integration of banks' guarantees and a system of lender of last resort.

Making the Euro workable

- Full integration or at least a Tranfer Union (authomatic compesation for troubled regions).

  So if a Spanish bank is in trouble, it has to be saved by an equity transfer at european level.

- The ECB as a lender of last resort to goverments, in the same way that national central bank already are.

- A higher inflation target in order to solve the wage rigidity and internal devaluation adjustment.

Conclusions

EMU cannot break up yet, because there would be hugely disruptive costs and high transaction costs.

Thus Europe needs an American style intregration such as United States of Europe (political, fiscal and economic intregration).

European leaders should admit that OCA theory is, and was, essentially right and now the theory is taking its revenge!