Does Optimal Currency Area theory suggest the need for greater multi-level governance in the Eurozone?

Holly Snaith
University of Sheffield

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- Introducing Optimal Currency Area theory
- How OCA has been interpreted and used
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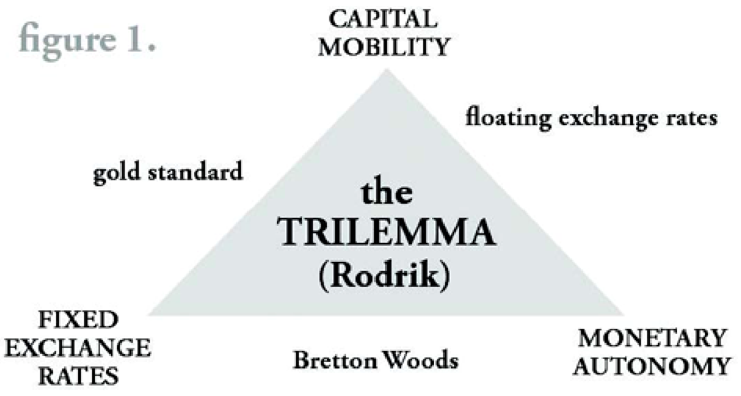
Optimal Currency Area Theory

- Paper by Robert Mundell, 1961 - ‘a theory of optimum currency areas’
- Later taken up (1963) by Ronald McKinnon and Peter Kenen, who added additional criteria
- Part of Mundell’s general work on exchange rate theory for which he won the Nobel prize in 1999
- Of theoretical and practical importance to EMU

The 'trilemma'

(source: Rationale magazine)



- OCA is a logical consequence of the Mundell-fleming model
- If you can't have capital mobility, fixed exchange rates & monetary autonomy, what goes?
- What's most politically acceptable?
- Mundell argued that if monetary autonomy was to go under a fixed regime, it was important that the conditions were optimal to minimize the loss
- Therefore: single currency to create more optimal conditions

Asymmetric shocks

‘assume that the continent is divided into two regions that do not correspond to national boundaries-the East, which produces goods such as cars, and the West, which produces goods such as lumber products…’

‘an increase in productivity (say) in the automobile industry causes an excess demand for lumber products and an excess supply of cars. The immediate impact of the shift in demand is to cause unemployment in the East and inflationary pressure in the West.’

OCA in the EU

'In Western Europe the creation of the Common Market is regarded by many as an important step toward eventual political union, and the subject of a common currency for the six countries has been much discussed.'

- An empirical, not a theoretical question
- Assumption of homogenous constituents
- Necessary criteria: Factor mobility (Mundell), economic openness (McKinnon), product diversification (Kenen), risk transfer (Wyplosz)
- Do these need to be in place beforehand (exogenous) or can they be created (endogenous)?

Governance implications

1. National boundaries and currency boundaries are not the same.
2. Asymmetric shocks may be regional, so there needs to be some kind of regional governance.
3. Countries need to work together at endogeneity.
4. Monetary and fiscal policy are co-dependent.
5. Oversight of governing bodies may, or may not, involve democracy. (See independent central banks…)

Conflicting interpretations

- ‘Economist’ vs. ‘Monetarist’
- Economists argued convergence should precede accession, Monetarists that it would succeed it
- Germany = economists, France = monetarists
- The convergence criteria and SGP were a fudge, a way of uniting these two views.
- But the theory itself isn’t unified.

OCA and EMU

- In 1961 EEC politically underdeveloped
- First attempt with the Werner plan 1969
- Currency ties with the snake 1973, Erm I (1979), ERM II (1999 - in tandem with EMU 1998)
- Clear that floating exchange rates are not an option for the European elites.

Debates: monetary vs. fiscal

1. As Wyplosz has argued, one of the tenets of a currency area is ‘risk dispersal’ ie fiscal transfers
2. The only provision for fiscal policy regulation was the SGP - which had a ‘no bail out’ clause
3. Most of the institutional focus was on monetary policy - and intentionally so because of the taboo on fiscal sovereignty
4. Does this create a governance problem?

Debates: multi-level governance

1. Mundell states that the optimum level is the region (supranational)
2. Equally, asmmetric shocks usually occur at the regional (subnational) level
3. By surrendering monetary policy autonomy, national governments become relatively less important
4. BUT fiscal policy is still the sticking point

The crisis

- Greece has shown how ineffectual the governance structure and regulation is
- This could have been predicted by OCA, because:
  - The participants are not homogenous or integrated
  - The (economist) criteria were fudged to ignore Greek/Italian/Spanish debt

Most importantly, tensions between monetary/fiscal and hierarchical governance structures are unresolved.

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