Part of WJEC

ECONOMICS

Resource

Optimal Currency Areas

Optimal Currency Areas – A Teaching Resource

Theory

In simple terms, an Optimal Currency Area (OCA) is a geographical area or region in which it 'makes sense' for there to be a single currency, because adopting a common currency will maximise economic efficiency. An OCA can be *larger* than an individual country, or sometimes *smaller* than an individual country.

Typically, economists believe that there are **four** key characteristics of an OCA (although some economists argue that there are up to **seven).** The key four criteria are:

1. There is **good labour and capital mobility** across the region – this will allow the region to respond quickly to economic shocks;
2. Prices and **wages are flexible** across the region;
3. There is a risk-sharing mechanism in place so that parts/countries within the OCA adversely affected by economic shocks can be supported by other parts/countries – this mechanism is usually regarded as being a **fiscal transfer mechanism**;
4. All parts/countries within the OCA must have a very **similar economic cycle** in order for a "one size fits all monetary policy" to be implemented effectively.

Task One

You do not need any particular knowledge of the EU or USA to answer the questions below – use your general knowledge, and discuss possible answers with others in your class.

a) Why might a UK university economics graduate find it i) easy and ii) difficult to take up a job with a bank in Italy?
b) Do you think there is good labour mobility in the EU?
c) Do you think there is likely to be good labour mobility across the USA (i.e. how easy might it be for a worker from Florida to move to Chicago for a job?)
d) What factors are likely to *prevent* wage flexibility in European countries?

Key Point: countries within an Optimal Currency Area must be highly **integrated** with each other and be very similar to each other. This means that they are able to share a currency because they can cope without using "exchange rate adjustment" as a macroeconomic policy tool.

Factors that affect labour market flexibility

Definition: labour market flexibility refers to the speed at which labour markets can respond to shocks and changes. We can think about labour market flexibility in terms of:

- **time** (e.g. hours worked, part-time/full-time, flexi-time, parental leave etc.)
- **skill** (e.g. moving between different occupations, transferable skills, outsourcing etc.)
- **pay** (e.g. performance-related pay, union activity/collective bargaining etc.)
- **location** (e.g. homeworking, flexi-working, telecommuting, culture/language etc.)
- **job security** (e.g. fixed contracts, ease of hire and fire, zero hours contracts etc.)
- **institutional** (e.g. ease of getting visas/work permits, ability to transfer pensions and other benefits between countries etc.)

Task Two

This is a short research task. Students can work individually or in small groups to find out the following information:

a) Find the titles of three EU labour market Directives, and note down the key aim of each Directive.

b) Find out about any three US laws that give rights to US workers. Do you think they give *more* rights or *fewer* rights than EU laws?

c) Find the names of 2 Trades Union from the UK, 2 from Germany, 2 from Spain, 2 from another EU country of your choice, and 2 from the USA; how active / influential is each of those Trades Union?

Why does an OCA need labour market flexibility/labour mobility?

When a country joins a single currency area, it loses the ability to use monetary policy to help control the macroeconomy – this means that it cannot use interest rates or exchange rates or the money supply (quantitative easing) to manipulate AD. To compensate for this loss of policy autonomy, countries with the single currency area must be able to handle economic shocks in other ways. One way is via labour flexibility/mobility.

Suppose that Country A suffers an adverse economic shock which causes economic growth to fall and unemployment to rise. The government / central bank cannot lower interest rates to stimulate AD, and so the economy risks getting stuck in a depression. In an OCA, the unemployed labour from Country A would simply move to other countries or parts of the OCA where demand for labour remains high, thus reducing the unemployment rate in Country A and restoring equilibrium.

Task Three

Study the data that follows and then discuss whether you think the Euro Area meets the “labour mobility” criteria for being an OCA.

Fig 1a – unemployment rate in Greece

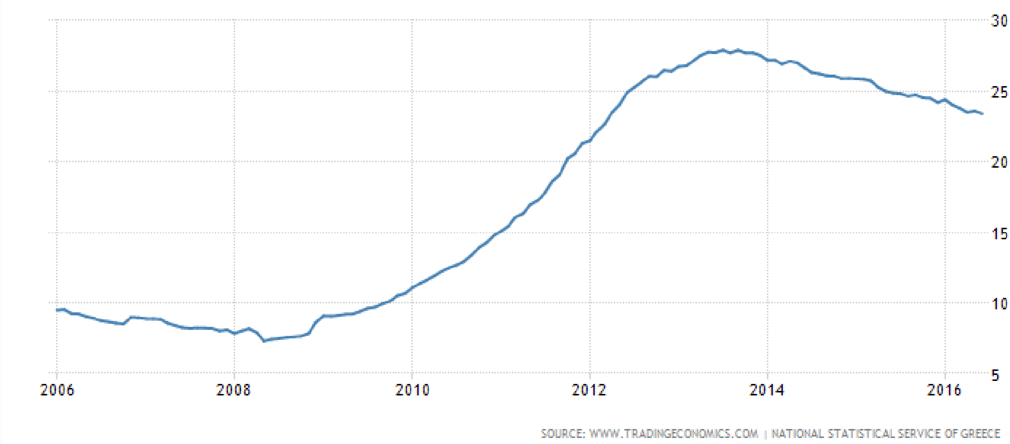
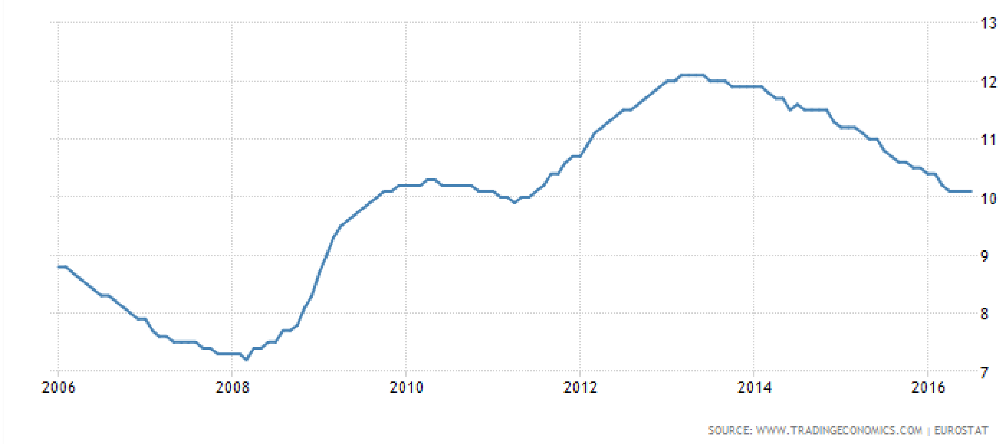


Fig 1b – unemployment rate in Germany

Fig 1c – Eurozone unemployment rate



Key points from the European Commission's 2015 Annual Report on Labour Mobility

- There were 11.3m intra-EU movers of working age, of which 8.3m were looking for work
- The main country-of-destination for intra-EU movers were Germany, UK, Spain, Italy, Switzerland and France
- The main country-of-origin for intra-EU movers were Romania, Poland, Italy, Portugal and Germany
- There has been a significant decline in East-West migration, and a significant increase in South-North migration
- Return migration makes up 25% of all intra-EU migration
- 44% of intra-EU migrants are regarded as very highly educated

Why does an OCA require countries to have similar economic cycles, and fiscal transfer mechanisms?

All countries/areas with an OCA will have to have exactly the same monetary policy stemming from an overarching central bank. This means that countries will need to have similar growth patterns, and therefore similar inflation patterns.

Suppose in an imaginary single-currency area, Country X has strong growth and reasonably high inflation of 6% whereas Country Y has negative growth and is at risk of deflation. Clearly, Country X requires a contractionary or tight monetary policy, with higher interest rates or a contraction in the money supply, and Country Y conversely requires a loose or expansionary monetary policy in order to stimulate growth. If the central bank decides to maintain its interest rates, then this could cause an overheating economy and potentially harmful inflation in Country X as well as prolonging the recession in Country Y. This is clearly not ideal for either country! Therefore, countries within an OCA must have similar economies.

It's not always quite that simple, though. Countries may appear to be pretty similar when a single-currency area is first established but economic shocks can have an asymmetric effect, thus causing different effects on different countries depending on the types of goods/services that they specialise in producing and the nature of their exports/imports. When this happens, and member countries cannot use their own monetary policy in order to stimulate the economy, then Optimal Currency Area theory says that there should be fiscal transfers from the high-performing areas to the weak areas i.e. taxes can be raised from strong economies and the revenue then spent in weak economies.

If such fiscal transfer mechanisms are not in place, then one of the only policy options open to struggling economies is to undertake a painful policy of "internal devaluation", which aims to reduce government spending so much that AD falls and domestic prices fall, which should in turn make exports more competitive (but at the same time worsen inequality and the provision of government services such as public goods, and goods with positive consumption externalities such as healthcare and education.).

Task Four

1. Read the passage on the previous page.

2. Explain what is meant by each of the following terms:
   a) Monetary policy
   b) Central bank
   c) Economic growth
   d) Inflation
   e) Disinflation
   f) Deflation
   g) Contractionary / tight monetary policy
   h) Expansionary / loose monetary policy
   i) Interest rate
   j) Asymmetric economic shock
   k) Fiscal transfer
   l) Internal devaluation
   m) International competitiveness
   n) Public good
   o) Positive consumption externality

3. Answer the following questions:
   a) State the roles and functions of a central bank
   b) Why will countries that have similar economic cycles have similar inflation patterns?
   c) Explain how tighter monetary policy could improve the economic situation in Country X
   d) Explain the key features of a "good" tax
   e) Explain why a policy of internal devaluation may worsen inequality and be generally undesirable.

Case Study – the Euro Area

The Euro was first introduced in 1999 and the size of the Euro Area has continued to increase since then – there are now 19 members of the Euro Area, covering 340m citizens. Monetary policy within the Euro Area is controlled by the European Central Bank (based in Frankfurt), which works closely with the national central banks of the individual member countries. A particular feature of the European single currency area is the existence of the "no bail-out clause" (Article 125 of the Lisbon Treaty), which technically makes it illegal for one member state to pay off the debts of another member state – the intention of the no bail-out clause is to encourage member states to be fiscally prudent.

In order to join the Euro Area, member states must meet a number of "Convergence Criteria". In simple terms, these are:

- **Price stability** – the rate of inflation is no more than 1.5% above the average of the best 3 performing Member States
- **Sound public finances** – government budget deficit no more than 3% of GDP
- **Sustainable public finances** – national debt no more than 60% of GDP
- **Durability of convergence** – long term interest rates no more than 2% above the average of the best three performing Member States on price stability
- **Exchange rate stability** – must have pegged their currency to the Euro for 2 years without any deviation

The sound public finances and sustainable public finances criteria, when combined, are also known as the **Growth and Stability Pact**. Whilst these criteria seemed highly sensible when they were first developed, there was no mechanism in place for ensuring that member states *continued* to adhere to them once they had joined the Euro Area – no checks, no punishments, no strategy. Some countries, such as Greece and Italy, hadn't really met the criteria in the first place but were effectively allowed to join the Euro Area because it appeared that they were heading in the right direction, and were core political members of the EU – they could not be allowed to fail!

Today, the Euro acts as one of the world's most important reserve currencies; in fact, in 2015, 20% of the world's foreign exchange reserves were held in Euros. It is also the 2nd most actively traded currency on a daily basis, with around a third of all foreign exchange transactions involving Euros. Furthermore, 40% of government and corporate debt is denominated in Euros.

But all is not well in the Euro Area. The economist **Paul Krugman** has argued that creating the Euro led many investors to believe that the risk of investing in different European countries had been eliminated, and therefore following the introduction of the Euro, there were huge capital flows from the European "core" (Germany, France, the Netherlands) to the European "periphery" (or the PIIGS countries, as they have since become known – Portugal, Italy, Ireland, Greece, and Spain). This led to economic boom in the periphery, and rising inflation; effectively this was one large but hidden asymmetric shock.

When the financial crisis struck, these capital flows suddenly stopped, leading to a huge fall in GDP but leaving these countries with overly-high inflation and wage levels. Without the ability to devalue their currency, the PIIGS floundered; the effect was worsened by labour markets not being as flexible as had been hoped, and the lack of fiscal transfer mechanism as a result of the no-bailout clause. By mid-2010, Greece came very close to defaulting on its debt. Despite the no bail-out clause, the European Central Bank (along with the IMF) stepped in to buy the bonds of struggling countries such as Greece and Ireland, leading some economists to argue that this would create a situation of moral hazard and encourage over-spending by other member states. Whilst this prevented default, the ECB required Greece to implement a severe programme of austerity which led to riots and great social unrest. The **European Financial Stability Facility** (EFSF) that was created by 27 member states in order to help with bailouts also went against the principle of no bail-out, although did help to create the possibility of fiscal transfer.

Case study – the USA

Some analysts have suggested that Europe could grow to be like the USA – effectively a United States of Europe. But the differences are great. The official language throughout the USA, and spoken by the majority of Americans, is English. It is possible to talk of American culture, but difficult to talk of European culture. The education system is fairly standardised across the USA. The economist **Greg Mankiw** has said that this "thinness of state borders" allows the US to operate as an OCA. The existence of a federal government (based in Washington D.C.) which hovers above all state governments and stands ready to provide assistance, is very different from the system of governance based in Brussels. The USA has a much higher labour mobility than the EU – around 40% of Americans were born outside of the state in which they live, compared with just 14% of Europeans. The economist **Barry Eichengreen** has estimated that labour mobility in the US is 2 to 3 times greater than that of Europe. Furthermore, when a particular state in the USA is suffering from recession, they receive 28 cents from the federal government's tax coffers for every $1 fall in GDP suffered – this so-called fiscal federalism acts as a safety net. And, bank deposits in US banks – whether local, state or national banks – are guaranteed by a federal (i.e. national) deposit protection scheme, and so bank bailouts do not end up being a burden on state finances.

In a now famous blog post for the New York Times, economist **Paul Krugman** provided some excellent examples of why the USA could be regarded as an optimal currency area. He suggested looking at the state of Massachusetts. At the end of the 1980s, Massachusetts suffered a large economic shock. For several years prior, the state had grown strongly on the basis of developments in microcomputers, but the shift to PCs and the bursting of a housing bubble created a huge unemployment problem. Now, the state could have engineered a huge fall in wages to correct the issue of surplus labour – but wages tend to be sticky downwards, and without the ability to devalue a currency (because Massachusetts, like the rest of the USA, uses the dollar), the only way to restore the unemployment rate back to its natural level was for the excess labour to leave the state. And that is precisely what happened.

In another example, Krugman discussed how the sub-prime housing crisis of 2007-2008 hit the state of Florida particularly hard. In addition to paying $33bn less in tax payments to the federal government as a result of a dire economic situation, Florida residents also gained an additional $3bn in federal unemployment benefits, $4bn in food stamps (a US benefit that allows poor families to buy basic food supplies), and a significant increase in the amount of Medicaid benefits (a US benefit that allows poor families to access healthcare services when they cannot afford to buy private health insurance). These fiscal transfers happened *automatically* and didn't increase the budget deficit or debt of the state of Florida.

Such fiscal transfers haven't always been a feature of the US. The Great Depression hit much of the US very hard, especially the so-called Deep South. Economists have shown that this part of the US was, until the 1930s, pretty much its own separate economic entity with hardly any labour flow between the South and the North, and a 50% difference in wages. It was only President F. D. Roosevelt's huge programme of Keynesian-inspired government spending under the New Deal in order to shift the US out of the Great Depression that really integrated the Southern US economy into that of the rest of the country. There has been some recent research by Michael Kouparitsas suggesting that the integration is not yet complete, and that only a section of the US actually forms an Optimal Currency Area (namely the area combining New England, Mideast, Great Lakes, Rocky Mountains and Far West; the Southeast and the Plains suffer more than the rest of the US as a result of changes to oil prices and interest rates, and the Southwest region responds very differently to economic shocks.

Task Five

Read the case studies and then complete the following table:

	Evidence suggesting it IS an OCA	Evidence suggesting it IS NOT an OCA
Euro Area		
USA		