

## IS THE EUROPEAN UNION AN OPTIMUM CURRENCY AREA?

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### Abstract

*The criteria to determine the optimum currency areas established by Robert Mundell have dominated the majority of the UME debates and the conclusions showed that Europe, made either of 6, 15 or more countries doesn't represent an optimum currency area, because it doesn't meet but only partially these criteria. Though, the adoption of the single currency can contribute to the increasing of the monetary optimality degree because the monetary unification accelerates the economic integration and thus leads to a better synchronization of the business cycles and, implicitly to the possibility of utilizing only one monetary policy in the countries part of the currency area.*

**Key words:** Optimum Currency Area, economic integration, asymmetrical shocks

### MATERIAL AND METHOD

The Mundell's theory concerning monetary areas, published in 1961, although subsequently was largely developed, was frequently used more to discourage than to encourage the foundation of monetary unions.

An important discussion connected to the influence of the economic integration over the EU monetary area optimality determined the separation of optimality criteria as follows:

a) *Exogenous criteria*, that must be fulfilled before forming a monetary union or before adhesion to a monetary union: *the degree of economic opening, symmetry of business cycles and shocks, inflation rates, mobility of production factors, production variation and price and salary flexibility;*

b) *Endogenous criteria*, which are considered to be fulfilled as an effect of monetary union achievement or adhesion to such a union: *trade integration, shock symmetry, financial integrity and mobility of production factors.*

In other words, appears the following question: *The states desiring to form a monetary union, but do not fulfill the criteria mentioned by the optimal monetary area theory, could fulfill these criteria subsequently to monetary area foundation?*

### RESULTS AND DISCUSSIONS

The criteria mentioned by Mundell (1961) in order to determine the optimal monetary areas prevailed in most of the debates concerning European Monetary Union, debates with conclusions underlying that Europe, formed either from 6 or 15 states, does not represent an optimal monetary union because it fulfills only in part the mentioned criteria.

A first reason would be that *the optimal monetary areas will never fit in the borders of a state or of a state union.*

On the other hand, the work markets in the main European states suffer from profound rigidity, the labor factor, less mobile in some states, is even less mobile taken as an average for all states.

It is estimated that in 1995, in EU the migration represented less than 1% from total population amount while in USA 3% of the population change their residency annually (Cerna, 2006). The greater mobility of the labor force in USA can be explained by: lack of linguistic and cultural borders, unitary system of study degree recognition, budgetary federalism, good functioning of the social and insurance protection systems, use of one currency and last, but not least, the

greater relevance of the statistical data concerning this phenomenon.

However, the labor force migration inside EU represents a fact with an underestimated real dimension, also due to the lack of a unitary reporting and collection system for statistical data concerning this phenomenon. In our opinion, *on a long term, it does not contribute to the increase of the optimality degree in the EU developed areas and poor developed areas* because the labor force migrates only in one direction, from poor states – as the ones found in transition to market economy – to developed ones, leading to appearance of deficits of labor force in certain areas of the ex-communist states economies. This situation increases the gap between the economic operators in the developed countries that enrich their productivity, financial power and consolidate their position on the market, and those found in the transition economies.

The extension towards East of EU made the entire Union monetary optimality to decrease as a result of great development gaps between old and new members, and also, because of the different economic structures and little correlated business cycles characterizing the West European and East European states.

The analysis of the economic integration effects over business cycles synchronicity led to two different points of view, known in the scientific debates under the name „European Commission point of view”, and „Krugman’s point of view”, respectively.

Distinct from European Commission that in 1990 affirmed that *as the integration degree increases, the asymmetrical shocks frequency decreases and the business cycles among the countries become more synchronized*, Paul Krugman declared in 1993 *that a closer integration has as result a greater specialization and implicitly an increase of the asymmetrical shocks*.

These points of view were discussed again and reconsidered by other authors.

Paul Krugman and A.J. Venables (1996) question the validity of the optimal monetary area theory, declaring that *in an economic and monetary union the tendency towards specialization appears in time* for its different

regions. Starting from the fact that in the United States the industrial production specialization degree is greater than in European states, it results that in time in the European Union will appear the same phenomenon, and a greater specializations means a smaller degree of production variation and as a result, *an increased vulnerability in front of asymmetrical shocks*.

Christian Hen and Jaques Léonard (2002), referring to the fact that EU weight in the world trade exchange registered a slight rebuff beginning in the '70 because the community exports are based less on the high technology areas contribution (characterized by a high demand) in comparison to USA and Japan, and mentions that the high technology products represent 26% of the Union exports against 30% for USA and 35% for Japan. Also, they state that one third of the increase registered by the American economy in the second half of the '90 is based on the IT and communication technology (IT&C), while this contributed with only 15% to GDP increase in EU.

Paul Krugman (1993) foresees that the monetary union will determine the member states to be more specialized in achieving products for which they register comparative advantages, starting from the example of an American region, New England, for which he observed that the economic integration had as effect the increase both in the specialization degree at regional level and also increase of the risk for severe recession appearance with regional character. At the end of 1987, the American state Massachusetts (located in New England) registered an unemployment rate of 2.5%, representing less than half of the national average, but the asymmetrical shocks taken place in 1990 determined the decrease of demand for the products made in New England, and this led to local economy collapse and to an unemployment rate almost four times higher. Therefore, Krugman reaches the conclusion that the economy integration does not guarantees the economic structure convergence because leads to geographical focus of an industry and formation of regional clusters.

This example confirms in a certain measure the thesis of the so called

*integration paradox*, formulated by Krugman. It is true that under condition of scale economies for which the economic integration opens the way, the increase of specialization degree seems possible. But, also, the situation to which we refer can be the result of different performances registered in research or teaching areas in the above mentioned states, or only a problem of option.

De Grauwe (1997) does not agree with Krugman's opinion concerning the integration effects, justifying that this starts from the theory according to which the industry focus will not exceed the member states borders, but the borders will have little importance in the regional delimitation of the industrial focus. Consequently, the asymmetrical shocks will not possess a national character, and in this case the floating currency rates would not be used for counterpoising these shocks. Also, among the Union member states there will be produced the trade creation phenomenon.

The European Commission point of view is supported by J. Frankel and A.K. Rose (1998a,b), that declare that a greater integration of the trade leads to a closer correlation of the business cycles among the states. More than that, the authors consider that the business cycles and trade integration are inter-connected processes and endogenous to monetary union foundation. Therefore, they demonstrate that the states that do not fulfill the optimal monetary area criteria before adhesion to the monetary union (*ex ante*) can fulfill these subsequently to this adhesion (*ex post*), because inside a monetary union the trade connections between member states are intensifying and this leads to increase of business cycles symmetry among the member states. As a consequence, the costs for passing to a single currency are considered to be relatively low.

The above mentioned reasoning promotes the thesis of *endogenous optimality of monetary areas*, according to which the formation of a monetary union ensures in time the optimality of the monetary areas included in the union because the single currency accelerates the economic integration process. Out of this reason it is estimated that

the optimal monetary areas theory is validating itself (Cerna, 2006). Therefore, the adhesion opportunity to a monetary union is granted a new perspective.

Such reasoning corresponds to an approach of *Lucas criticism* type, according to which under hypothesis of rational expectations the initially considered parameters in an econometrical model will not be maintained. The policy changes determine a behavior modification of the economic agents in order to adapt to a new reality. Consequently the econometrical models cannot be used for foundation of economic policy objectives.

Additionally, the verification of optimality criteria observation is relatively difficult and not very accurate. For example, if we consider the shock similarity criterion the difficulty consists of establishing the symmetrical and asymmetrical shocks causes. These shocks can be induced by modifications registered by demand or supply, can be the result of inefficient or even abusive national macro-economical policies can possess a temporary or permanent character.

The validity of the endogenous optimality in monetary area theory is considered by H.A. Hallett and L. Piscitelli (2001) to be uncertain and dependant in a great degree of the structural convergence in the starting stage of a monetary union. If it is decided the transition to a single currency under conditions of structural divergence, this divergence will accentuate itself.

This point of view justifies the adhesion conditioning to UEM according to Maastricht criteria that imply that the states desiring to join the Euro area to have low and similar inflation rates, close interest rates on long term periods, a high degree of financial convergence and to observe the budgetary discipline (fact allowing the inflation rate to be maintained to a low level) and a steady currency against Euro in the last two years before adhesion (the possible exceeding of the fluctuation limit of  $\pm 15\%$  shows a high volatility of the exchange rate and the fact that the state desiring to use Euro does not have a convergent enough economy with the Euro area).

The European Commission point of view is in a great extent supported also by empirical studies analyzing the effects of trade integration over the shocks symmetry in case of the transition states.

For example, Ian Babetskii (2004) reaches the following conclusions:

- trade focusing leads to increase of symmetry of shocks registered at demand level;

- the integration effects over the asymmetry of shocks registered by offer are different from one state to another;

- reduction of exchange rate volatility has a positive effect over convergence of shocks registered by demand.

As a result, we can estimate that the results obtained as concerns shocks produced over demand support the hypothesis of monetary areas endogenous optimality.

Also, the results obtained by Ian Babetskii acknowledge the statement of P. Kenen (2001), stating that the impact of the trade integration over shock asymmetry depends on the shock type.

## CONCLUSIONS

Against numerous critics UEM can prove in time its viability by cumulated action of several factors.

First, the common currency benefits (that is also a universal currency) and its effects applied towards integration of product, service and financial markets or increase of the convergence degree are often underestimated or ignored.

Second, the capital mobility allowed by an integrated financial market (the greatest worldwide) can replace the labor force mobility facilitating the adaptation process imposed by modification in supply and demand. The monetary union in itself is an integration factor that will develop at the same time the mobility of production factors and will reduce the probability of asymmetrical shocks.

Third, the regulation according to which the floating rates are superior to the steady ones or to a common currency in diminishing the asymmetrical shocks effect is not always valid because is conditioned, in case of free capital circulation, by the adopted monetary

policy, importance granted to financial policy and economy opening degree.

The UME member states register a high volume of mutual trade exchanges, and that justifies the option made in favor of a common currency.

Fourth, because it is founded on internal stability maintenance principle, UME ensures by means of BCE the premises of a healthy and coherent economic development for the Euro states.

In this context, Tomasz Koźluk (2003) stated: „Assuming that adhesion to a monetary union should increase credibility (of monetary policy – n.n.), it becomes easier to maintain inflation to a low level”.

Consequently, the Central European Bank must promote a prudent monetary policy in line of reaching his basic objective: price stability. Its mission becomes more difficult as the Euro area extends.

We must underline that the adhesion to a monetary union does not entirely solve the various problems the national economies confront, as the ones connected to unemployment, production or inflation, but implies toleration of some constraints and some costs. On the other hand, on background of increase of the economic opening degree, production variation, the monetary union adhesion benefits, as concerns liquidity increase and financial stability, can compensate the additional adjusting costs necessary for joining the union.

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