

## Optimal Currency Areas

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I am very pleased to be a participant in this ECB Central Bank Conference on the tenth anniversary of the creation of the euro and of the European Economic and Monetary Union (EMU). While it is difficult to specify the conditions for an optimal currency area, it is clear that the eurozone has been a very successful currency area. The euro was launched without serious problems and the ECB has succeeded in achieving the low inflation rate that is its single policy mandate. The desire of other countries to join the eurozone is further evidence that it is doing something right.

Rather than trying to define an optimal currency area or to state the conditions for an optimal currency area, I think it is better to ask the question: When is it in the interest of an outsider to join an existing currency union? And when is it in the interest of the existing members to add that outsider? Of course, this can be applied to the initial decision of any two or more countries to form a currency union.

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I will begin by reviewing the advantages of a currency union from the point of view of the potential entrant and of the receiving group. I will then discuss two negative aspects of a currency union and examine the economic conditions that affect the seriousness of these negative aspects.

### Traditional Advantages of a Currency Union

Since this session is subtitled “An Academic View,” I will begin with the three standard textbook advantages of a monetary union.

*Currency convenience.* A traveler in the eurozone does not have to carry a different currency for each county that he will visit. This is an advantage to potential joiners, to the receiving group, and to outsiders like myself. The importance of this is not large in today’s world of credit cards and ATMs.

*Price comparability.* With a single currency, a shopper in one country can easily compare the price of a particular good in different places, thereby minimizing the cost of purchase and strengthening the efficiency of the market. This too is a potential gain both to the joiner and to the existing group. But I have never understood why this is considered significant. The housewife in Madrid cannot shop for her

daily bread in Frankfurt while the wholesale buyer has always been able to compare the prices of steel that were stated in Spanish pesetas and German marks with the help of a pocket calculator.

*Cross border investment.* A single currency eliminates the direct exchange rate risk of cross-border investment within the currency union. This also is a potential gain to both the joiner and the existing group. Each can invest in the other without worrying about the potential loss if the exchange rate changes adversely. To the extent that this causes cross-border investment to occur that would not otherwise have happened, it presumably increases the efficiency of the international allocation of capital. But the amount of this gain is reduced to the extent that firms would otherwise hedge that currency risk by borrowing in the host country to finance their cross-border fixed investment and would use currency futures to hedge the currency risk of cross-border portfolio investment.

### Transition Gains

The academic literature on monetary unions focuses on the *continuing* advantages and disadvantages of membership. In practice the creation

of the European Monetary Union demonstrated that there can be significant transition gains for some of the joining countries.

Before they joined the EMU, several countries had high inflation rates and correspondingly high rates of interest. The requirement to reduce inflation and interest rates as conditions of membership gave these countries the political ability to make these healthy changes. Once in the EMU, the lack of independent national monetary policies preserved the low inflation.

The EMU membership criteria imposed on those who would join the EMU also included a reduction in the fiscal deficit and in the national debt. Although not all applicants satisfied these standards at the time of entry, their attempts to do so did initially help to reduce government spending and to limit fiscal deficits.

#### Five Additional Persistent Gains for Joiners

As I look at the EMU experience I see five additional ongoing gains that accrue to those who join.

*Inflation Discipline.* Although not every monetary union has a commitment to low inflation, the EMU has had one from the beginning

with the ECB's single goal of price stability. Countries with a tradition of high inflation, often driven by union wage demands, benefited from the discipline imposed by EMU membership. Unions recognized that wage increases in excess of productivity gains could not be absorbed by an exchange rate adjustment but would lead to a loss of competitiveness and reductions in employment.

This gain to the joiners who had previously had high inflation rates did bring with it a risk to the low inflation members. Since monetary policy in the EMU is set by a consensus of all member countries, there was the danger that an increase in the number of countries with a history of high inflation could lead to a more inflationary monetary policy for the union as a whole. Fortunately that has not happened in the EMU.

*Exchange Rate Discipline.* Any monetary union automatically prevents member countries from seeking to gain competitive advantage by currency devaluations or to offset excess wage increases in this way.

This is closely related to the inflation discipline but goes beyond it since it is implicit in any monetary union. It is a gain to those countries that had a history of devaluations but a risk to those existing member

countries to the extent that there comes to be increased pressure to devalue the common currency.

*Lender of Last Resort.* Commercial banks always have the potential need for a lender of last resort when they experience a liquidity problem.

Under those circumstances, central banks do provide liquidity against illiquid collateral. In this age of global banking, the needs of a domestic bank or of a group of domestic banks may exceed the appropriate lending ability of the national central bank and the fiscal capacity of the national government. This is an even greater problem if the commercial bank needs foreign exchange. Shifting from the resources of a single national bank to the resources of the central bank of the monetary union provides a more powerful lender of last resort. This is an advantage to any country that joins but is a potential risk to the existing members if the resulting lending is against overvalued collateral.

*Expertise.* Although some small countries have a rich supply of wise economists and skilled bankers, not all of them do. The complex decisions of monetary policy and banking supervision can benefit from the larger pool of talent that can serve on the monetary policy board of a

multi-country union and on the supervisory and research staffs of the central bank.

*Political Union.* A monetary union need not be a precursor of a political union. But the EMU and the euro were seen by many in Europe as ways of strengthening the European union and developing support for a stronger political union. If individuals carry euros in their pockets instead of French francs or Italian lira, they would be more likely to think of themselves as Europeans. If they saw the power of the central banks shift from their own national capitals to Frankfurt, they would see the European Union as a more significant political force. For those who favored this transition to a stronger political union, the creation of the monetary union and the single currency were advantages.

#### Disadvantages of a Currency Union

The currency union implies a single monetary policy and a single exchange rate for all member countries. A country that joins a currency union therefore gives up the opportunity to select a monetary policy that it regards as optimal for its own circumstances. Similarly, the country's exchange rate cannot respond to the market forces by which

changes in technology, taste, and the behavior of other countries affect its international competitiveness.

A country that considers joining a currency union must weigh these disadvantages against the advantages that I have described in the earlier part of these remarks. This balancing will differ from country to country. Each country must consider the extent to which it can expect to gain from those advantages and the extent to which it would be disadvantaged by the single monetary policy and single exchange rate.

The adverse effect of the single monetary policy and single exchange rate will depend primarily on four conditions.

*Industrial similarity.* If all of the countries in the currency union had the same industrial composition and were subject to the same shocks to technology and demand, the lack of individualized monetary policy and differential exchange rate movements would be irrelevant. A country that considers joining should evaluate the extent to which a monetary policy designed for the currency union as a whole would be the best one for itself. We see in the EMU substantial differences among countries in the distribution of industries that are reflected in differences in unemployment rates and in trade balances.



*Labor Mobility.* A fall in demand in a particular country or region will lead to less unemployment if the labor force is geographically mobile and can shift to other areas where demand is stronger. This is one way in which the United States has been able to cope with cyclical and structural changes in demand. The ability to achieve such labor mobility in a currency union depends on several features. The variety of languages clearly inhibits labor mobility within the euro area. Labor regulations, union restrictions, and licensing rules may also impede such geographic mobility.

*Fiscal Structure.* Fiscal policy is important in two ways: the role of the central fiscal authority and the freedom of the individual national fiscal authorities. In the United States, the central government collects about two thirds of all taxes and an even larger part of cyclically sensitive income and profits taxes. When demand falls in a particular part of the country, the amount of taxes paid from that region to the central government falls. This automatic fiscal policy dampens the local decline in net income and therefore stimulates demand relative to what it would otherwise be. That helps to compensate for the lack of an independent monetary authority for the region. In a currency union

with a very small central fiscal authority, like the EMU, there is no such fiscal counterbalance to local swings in domestic demand.

Members of the currency union can of course vary national taxes and spending to provide a local stimulus to offset declines in demand. But this ability to run deficits creates a problem for the currency union as a whole. Because there is a single currency, large fiscal deficits in any single country do not create the market feedback in the form of higher interest rates or a weaker currency as it would if the deficit country had its own currency. Although there are some relatively small differences in national interest rates, the primary effect of any country's fiscal deficit is diluted and spread over the entire currency union, causing the common interest rate to rise and the overall currency to decline.

While this is an advantage for the country that alters its domestic policy, it is a disadvantage for the currency union as a whole. That led to the Stability and Growth Pact that, in principle, limits the extent of any country's fiscal deficit. Some rule of that type is a necessary feature of any currency union in which fiscal actions remain decentralized among the member governments. That limit on each country's fiscal policy is a

further disadvantage for countries that consider joining a currency union.

*Willingness to Sacrifice.* The potential success of a currency union depends on the willingness of the member countries to accept what the monetary authority regards to be best for the group of countries as a whole. At times, that will mean a policy that is directly counter to the interest of specific countries within the currency union. The willingness of those countries and of their voting publics to support a common policy that is clearly against their interest is a critical feature that will govern the long-term success and survival of any currency union.

### The Current Challenge

The first decade of the EMU has been a clear success. But it is about to be challenged by more difficult conditions: a financial crisis and sharply declining economic activity on a scale that exceeds anything that Europe experienced in the past decade.

Not all EMU countries will be affected equally by the evolution of the European economy or by the policies of the ECB. Some governments or

political parties within countries will wish that they had more control over their monetary policy or more ability to pursue a very aggressive fiscal policy.

Because of a limited willingness to make sacrifices for the benefit of other EMU nations or for the EMU as a system, some of those governments or politicians may seek to exit the EMU or may threaten that they will do so unless policies are changed.

In short, the next few years will be a very challenging time for the ECB and for the European political process.

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