Does the scope of Optimal Currency Area theory suggest the need for greater (Multi-Level) fiscal Governance in the Eurozone?

Abstract

Optimal Currency Area theory (OCA) is a body of research that has been highly influential, since its inception in 1961, on the discourse and design of Economic and Monetary Union. In particular, the Convergence Criteria, Stability and Growth Pact and independent European Central Bank all accord with the prescriptions suggested by proponents of OCA as a precondition for currency union. This paper first outlines the key aspects of OCA theory, in order to trace the degree to which debates within OCA have been embedded within the EMU institutions during their creation. I suggest that one particular aspect of OCA’s implications remains unresolved within the Eurozone’s economic framework: namely adequate fiscal governance, in particular a developed and integrated role for subnational actors within EMU’s decision making processes. This reflects a general lack of formalisation of the kind of multi-level processes that frequently happen in practice within currency unions. The final part of this paper goes on to consider how these have already been formed during the financial crisis, and whether a greater role for formal multi-level negotiation is likely to prove necessary to the future stability of the Euro.

Introduction

Optimal Currency Area theory has long had a complex and difficult relationship with the empirical reality it claims to offer purchase on. From its inception, OCA has served as both an idealised, abstracted model; an empirical proposition; a set of (disputed) political guidelines and a retrospective justification for policy choices. OCA can be taken on face as simply a set of answers to the question of ‘whether it makes good economic sense for each country to have its currency’ (Baldwin and Wyplosz 2006, p.351), but how substantive and unified this answer is in practice is a moot point. The basic principles of what constitutes an optimal currency area are variously and often disparately conceived of: according to Mundell, it is ‘the region – defined in terms of internal factor mobility and external factor mobility’ (1961, p.661); to McKinnon it is an ‘area within which monetary-fiscal policy and flexible external exchange rates can be used to give the best resolution of three objectives’ (full employment, balance of payments, and low inflation) (1963, p.717); and to Baldwin and Wyplosz, ‘the best border of a currency area corresponds to the situation when the costs and the benefits from sharing the same currency balance each other’ (2004, p.331).

It should be evident from this small sample that the definition of Optimal Currency Area theory – and, therefore, what might be sought empirically in order to support or deny the theory’s claims – is as much a point of contestation as whether an OCA might be found to exist in practice. The interesting consequence of this is that OCA can be seen as a theory to be bent to any will. As a consequence of this malleability the (occasionally contradictory) discourse and debate surrounding OCA has been inexplicably bound up with the process of monetary union in Europe. Even Robert Mundell, usually credited as the originator of the theory in his 1961 paper on Optimum Currency Areas (although other authors, such as Demopoulos and Yannacopoulos (2004), point to the influence of Lerner’s (1944) work on the correlation between common markets and common currencies in shaping these ideas) was himself explicit about the potential for practical realisation in the then-European Community of six. He states that the realisation of a currency union in line with OCA could be envisaged ‘only in areas where political organization is in a state of flux, such as…in Western Europe’ (1961, p.661).
Initial attempts to enact monetary union took place very much within the shadow of the OCA debate. Closer monetary and economic integration has been a cornerstone of the EU since the inception of the Treaty of Rome (Nugent 2006, p.43-4), Article 2 of which states that the EEC should ‘promote throughout the Community a harmonious development of economic activities’ by ‘establishing a common market and progressively approximating the economic policies of Member States’. It is clear that economic integration has been critical from the outset. Nevertheless, no formal plan for integration appeared until the ambitious Werner report of October 1970, which fell rapidly by the wayside due to the turbulent economic climate in the early 1970s coupled with lack of political will (Dinan 2005, p.60-74). Whilst this attempt at achieving ‘the establishment by stages of economic and monetary union in the Community’ (Werner 1970) never really got off the ground, it did set the context for the progressive attempts at monetary integration that would take place throughout the following decades. Indeed, the presence of serious debate about the feasibility and likely pre-requisites for a currency union within the economic literature was undoubtedly an important contextual factor in the resurgence of an idea that had been present but latent since the 1950s. Indeed, the considerations of OCA were prominent in the decision of Sweden and the UK not to join EMU (HM Treasury 2003, Calmfors, L et al. 1997).

Aside from playing a politically salient role, OCA has also been significant within the broader economic environment. Whilst the specific content of OCA relates to the conditions under which a currency detached from existing nation-state organisation – in practice, either within or more likely between countries – becomes economically worthwhile, OCA is also notable as for its role within macroeconomic literature more generally concerned with currencies and their role. As Dellas and Tavlas (2009) comment, OCA originated in the debates regarding the desirability of fixed versus floating exchange rates, but is significant within this for ‘the differences in characteristics among economies in the real world’ (p.1118). In this respect, OCA may be taken as one of the most empirically significant academic antecedents to EMU, and it is arguably this feature that has led to its absorption by policy makers. This is analogous to Giddens’ notion of a ‘double hermeneutic’, whereby there is a process of interaction between social science analysis and everyday practice, through which actors incorporate analytical concepts into their lived behaviour. The role of OCA therefore can be seen as multifaceted in its significance and expression.

**Competing narratives of optimal currency area theory**

The degree to which has, or should, be considered to exist within the current framework depends fundamentally on what OCA is. This is an important consideration given the accusations levelled at OCA over the years. In particular, one is often repeated: that OCA is ‘something of a dead-end problem’ (Johnson 1969, p. 395). As Willett and Tower (1971, p.290) argue, it is necessary to go beyond the narrow and speculative presentation of the OCA problem offered by Mundell (1961) in order for the concept to provide value, but in so doing the parameters of the issue can become so vague as to be analytically useless. In this initial, literal form it would seem quite apparent that OCA is not readily applicable to EMU as enacted: as McKinnon (2000, 2004) argues, the earlier Mundell ‘seems to argue in favor of making currency areas smaller rather than larger’ (2000, p.1) thus implying an incompatibility between a strict interpretation of OCA theory and the 17-member, heterogenous Eurozone. There is, however, a paradox – as McKinnon goes on to elaborate – in that the later (post-1970) Mundell went on to advocate currency unions as large as could realistically be made possible in order to take advantage of exchange rate stability, and Mundell (1973a, 1973b) therefore was to support steps to implement the
nascent EMU during the 1980s and 1990s. This tension between different interpretations of the costs and benefits of currency unions was to pervade academic discussion of EMU and reflects deep fault lines in the practical arguments for EMU. Nonetheless, ignoring the critical uncertainty inherent in the theory, numerous authors have criticised the use of OCA as an analytical framework: the ‘dead end’ problem.

The argument persists on several fronts: that OCA is academically irrelevant or a pointless debate, or alternatively that it has been rendered obsolete by the form and structure of the Eurozone. A key accusation is that the Eurozone, as it stands, is arguably not an optimum currency union insofar as it is possible to collate evidence to assess the three principal criterions that support an OCA: labour market and capital mobility, openness, and diversification and similarity (drawn from Mundell 1961, McKinnon 1963 and Kenen 1969, for a more complete list of factors see Tavlas 1993, p.666). All these factors can help mitigate the risk and impact of asymmetric shocks, which are perhaps the biggest economic (if not political) risk to the harmony of a currency union. An asymmetric shock is, in layman’s terms, ‘when something unexpected happens that affects one economy (or part of an economy) more than the rest’ (Bishop 2004/The Economist). This is particularly important within the context of a currency union, where the boundaries of an economically depressed region may not accord with the structure of political representation, leading to what Verdun (1999) characterises as a democratic deficit in the institutional design of EMU.

To paraphrase Mundell’s example (1961, p.658-661), relating to the production of cars and lumber products in the East and West Americas, demand shifts between two regions within a currency area will cause unemployment in one region, and conversely, inflation in the other. Attempts to use a single interest rate (as opposed to floating currency movements corresponding to regional outputs) to rectify this shift will necessarily be optimal for neither region. The empirical evidence on the three criteria is mixed to say the least (see for example Bayoumi and Eichengreen 1997), but in general the performance of Eurozone countries on each of the indicators is highly variable, and the degree to which individual economies exhibit convergence along these tendencies has not been a good predictor of political commitment to EMU. Fundamentally, this critique suggests that since the Eurozone cannot be shown to fulfil the predictions of OCA, the theory no longer offers useful insights into the economics of convergence.

Aside from whether the Eurozone can be considered an optimal currency area (ex post or ex ante), there is a secondary accusation levelled at OCA theory, that of academic irrelevance. This argument relates principally to other spheres of macroeconomic literature, notably currency exchange rate policy coordination under uncertainty (Hughes Hallett, Holtham and Hutson 1989), which is presented by Schelkle (2001) as a more credible recent alternative. The thrust of this critique relates to temporality. Schelkle argues that the arguments of ‘modern exchange rate theory have undermined basic tenets of the OCA framework’ (p.4) and that therefore it is no longer a relevant contemporary explanation. Empirically speaking, the economic context in which OCA arose (namely, the Breton Woods system of fixed exchange rates) entails that the substance of the debate was concerned as much with how to exploit flexible exchange rates, as with creating large single currency blocks. The contemporary context of a largely floating exchange rate regime renders this latent focus less salient, and entails that the costs of abandoning monetary autonomy seem comparatively more obvious. However, the particular context of Europe is particularly interesting because of the EU’s obvious historic commitment to fixed exchange rates.
Since the Single Market liberalised capital mobility within Europe, EU member states have been compelled to choose between an independent monetary policy and fixed exchange rates (Wyplosz 1997, p.3). Floating exchange rates have never been especially palatable to most European member states, long wedded to the idea that exchange rate volatility is especially damaging to economic growth – but by taking flexible exchange rates off the table, participants tied their hands in other respects (according to the ‘trilemma’ first theorised by Mundell and Fleming in 1962/3). Before the Euro, three regimes had been attempted – the ‘snake’ in the from 1971–1975, which failed after the collapse of the Bretton Woods agreements, EMS I from 1979–1992, EMS II (1992 – present), and eventually full EMU (1999 – present). Within the EMS, which sacrificed independent monetary policy, countries such as France had been faced with the uncomfortable choice between frequent revaluations to maintain ebbing competitiveness, or effectively relinquishing their monetary policy to accord with that set by the system’s anchor currency, the Deutschmark (Baldwin and Wyplosz 2006, p.336). Under EMU, members faced the possibility of being able to regain (albeit collective) influence over monetary policy, as ‘the countries participating in the euro will recover within this framework the collective monetary autonomy which they had lost’ (Strauss-Kahn 1998) rather than the previous passive adoption of German interest rates.

In the face of both of these criticisms it might seem that OCA is indeed dead in the water. However, to borrow the argument of Hay (1999) what matters in this (hermeneutical) context is not whether a particular theory (OCA) accurately explains the conditionality of monetary unions, but whether the actors involved think it does. And, as is argued in the section below, there is ample evidence that politicians acted as though the tenets of OCA theory (as they chose to interpret them) were true. In this context the disagreements at the heart of OCA are extremely relevant, since they allow political actors to argue essentially contradictory things whilst all claiming to do so from the pulpit of optimality. This is increasingly relevant, for one of the stipulations of OCA that was not adopted by EMU is ‘that the domain of fiscal policy and that of the currency area must coincide’ (Schelkle 2001, p.16) in order to offset asymmetric shocks. Schelkle uses this to evidence the redundancy of regarding the ex ante EMU as a manifestation of OCA. But the economic crisis has called into stark relief the importance of the relationship between the two. The schisms in the narrative of the theory itself have been appropriated and incorporated within the structure of EMU – but this selectivity has ensured that some of the most important provisions of the theory have been overlooked. The institutional legacy is still significant.

**OCA and the Maastricht framework**

The principal split in OCA, both in theory and in practice, relates to whether the conditions of optimality can, or should, be achieved ex post or ex ante. That is to say, can a currency area become optimal? And if so, does it matter who joins? This has been an ongoing debate in OCA reflected by a major split in the cost/benefit analysis of creating a currency area, exemplified the ‘early/late’ Mundell split of McKinnon’s presentation, outlined above, and the ‘new OCA’ of Tavlas (1993). Furthermore, the creation of EMU has (unsurprisingly) been an important watershed moment. Jonung and Drea (2009) suggest ‘that US academic economists concentrated on the question “Is the EMU a good or bad thing?”’, usually adopting the paradigm of optimum currency areas as their main analytical vehicle’ (p.3) but this

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1 Also known as the ‘inconsistent trinity’, which states that governments can choose only two of the following three policy options: fixed exchange rates, full international capital mobility, and monetary policy autonomy.
characterisation disguises the more recent ex post slant on the currency area issue which asks, ‘how can EMU be made a better thing?’.

Aside from being an important question in and of itself for contemporary debate (and one to which we return subsequently), the ex post/ex ante debate as imported from OCA theory was a crucial reference point during the creation of EMU, and design process of its rules and institutions. The group of theorists who argued that the OCA conditions for monetary union should be met in their entirety before Stage III be attempted (Levitt and Lord 2000, p.58, Maes 2004, p.17) were termed ‘economists’. This essentially corresponds with the German position, which reflected a national fear of inflation and reverence for the independent role of the Bundesbank, and a ‘missionary-colonialist’ desire to export this throughout the rest of Europe (Connolly 1995, p.389). By contrast, ‘monetarists’ (represented politically by the French position) argued that the level of economic homogeneity sufficient to ensure the success of the currency union can only be met endogenously, ex post (for this perspective’s primary academic exponents see Frankel and Rose 1997, 1998).

The very creation of Monetary Union – in three stages – was designed as a compromise between the two differing schools of thought. It was intended that member states would only be permitted to proceed to Stage III of convergence (the irrevocable fixing of the member currencies and de facto creation of the Euro) on the proviso that they fulfilled a set of agreed economic indicators (Sandholtz 1993). These – the Convergence Criteria – consist of: price stability, sub- 3% budget deficits and sub- 60% public debt, successful participation in the European Monetary System (EMS) with no recent devaluations, and low long-term interest rates (Protocol on the Convergence Criteria, Art. 1-4), a clear nod to the ‘economists’. The transition to Stage III would be conducted in 1997 if seven of the twelve member states (prior to the 1995 enlargement) met the criteria; if not, the deadline for the progression to Stage III of EMU was set for 1999 at the latest (Mayes and El-Agraa 2007, p.214). This time limit conceded to the demands of the ‘monetarists’.

The financial crisis and governance

Most macroeconomic literature is notably short on governance considerations. Indeed, the structure of EMU itself has fallen short of fully taking account of the governance implications of the new framework. Governance is more than rules and institutions: it is ‘the manner in which power is exercised in the management of a country’s economic and social resources’ (World Bank 1991, p.1). It involves relationships to be negotiated, contrasting agendas, and above all the exercise of power over which accountability is due. Nonetheless, the structuralised mutual relationships necessary to govern a multi-state union effectively have been particularly absent in the creation of EMU. This partly reflects the political sensitivities of the European project, which has been oriented around the achievement of political integration via less contestable economic and technocratic means. The problem is that economic integration has acutely political consequences – as predicted by OCA theory.

The Stability and Growth Pact is a case in point. Initially, the fiscal dynamics of EMU were to be contained by a single agreement, the SGP. The SGP’s primary function is to enforce budgetary stability, defined as a sub-3% budget deficit. The TEU specifies that the commission ‘shall monitor the development of the budgetary situation...with a view to identifying gross errors’ (where government budget deficits exceed the 3% ‘reference value’ (Art. 104c)), and the SGP elaborates on the means of achieving this aim, through the two opposing rationales of the Pact: Regulation 1466/97 embodying the
preventative’ arm, and 1467/97 the ‘deterrent’ or ‘corrective’ arm (Breuss 2007, p.V, ECOFIN 1997a). Both instruments were subsequently amended in 2005 following a saga of recession and power politics. In 2002, both France and Germany began to exceed the 3% deficit limit due to unexpectedly sluggish growth and rocketing unemployment rates (ECOFIN 2003, p.15-8, U.S. Department of Labor, 2008). By 2004 the deficits in both countries had risen above 3.5%. The ECOFIN council decided in November 2003 whether to impose sanctions on France and Germany, and, under the terms of the SGP, should have done so. However, the Council voted against sanctions under Art. 104 (9) of the TEU, and subsequently in favour of an ‘abeyance’ of the terms of the SGP for France and Germany (an act of questionable legality, which the Commission referred to the ECJ (Baldwin and Wyplosz 2006, p.413, Commission 2004). This led to a revision of the SGP (1055/2005 and 1056/2005), which significantly downgraded the impact of the ‘corrective’ arm, thereby institutionalising discretion over punishment for excessive deficits.

This highly restrictive notion of how fiscal policy should be governed within a common monetary policy has been endemic to EMU – and is at odds with OCA. Baldwin and Wyplosz (2006) add three political criteria to the economic stipulations above: fiscal transfers, homogenous preferences, and solidarity. Of these, fiscal transfers (that ‘countries agree to compensate each other for adverse shocks form an optimal currency area’ (p.358)) are the most immediately salient to the institutional framework. That the member states have taken a rather narrow angle on fiscal policy is undeniable. Rather than actively coordinating and offsetting policies horizontally and vertically within and between states, as suggested by OCA, concerns that EMU would generate a free rider problem generated a form of regulation that enforces a restrictive, quasi-neoliberal line on budget deficits. This line has only been exacerbated by the current sovereign debt crisis. Whilst the election of Francois Hollande to the French presidency calls into question the viability of the fiscal treaty (Treaty for Stability, Coordination and Governance), if it persists in its current form it is likely to further embed the fiscal nationalism apparent in the currency area. This treaty formalises the role of the European Stability Mechanism (which, at some €700bn with leverage is barely scratching the surface of the scale of public debt, with Germany’s debt alone standing at €2.08 trillion) but its main role is to reinforce the ‘budgetary discipline’ of its predecessor. The 3% target remains the primary goal. The deckchairs have been rearranged.

Whilst so many other aspects of the theory (coherent or not) have been absorbed into the framework, fiscal transfers are notably lacking. Commentators such as the FT (Munchaü 2011) have called for the introduction of Eurobonds, to federalise European debt obligations above certain levels and therefore lessen the asymmetric impact of the common monetary policy (which led to a Commission green paper in November 2011 calling for ‘a broad public consultation on the concept of Stability Bonds’ in the wake of the sovereign debt crisis (European Commission 2011, p.2). Furthermore, none of this effectively considers the composition of modern European states, with multiple points of fiscal responsibility and commensurately dispersed accountability. As Spain have experienced, it can be difficult to negotiate the fiscal responsibilities of subnational governments (the independently accrued debts of the ACs being largely responsible for S&P’s downgrade of Spain on April 26th (Reuters 2012)). The risk of asymmetric shock within an OCA is that they may be acutely regional, implying a need for greater acknowledgement for the role of subnational governments within the fiscal framework. This, too, is pointedly overlooked within the current framework. If OCA is dead, it is perhaps worth considering why the predictions of its theorists and its governance implications are still causing problems in EMU.
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