DO THE NEW MEMBER STATES FIT THE OPTIMUM-CURRENCY-AREA CRITERIA?

1. INTRODUCTION

The question of whether particular countries fit the Optimum-Currency-Area (OCA) criteria has been the subject of a growing body of empirical literature. Recently, the issue was taken up in the context of the new EU member states (NMS), which are expected to join the Economic and Monetary Union (EMU). The OCA theory, with its many empirical operationalizations, offers a valuable and concise tool to assess the costs and benefits of this important decision.

This chapter investigates the OCA-implied criteria using two different empirical approaches. First, we examine a number of conventional OCA criteria, such as the openness to trade with the EU-15, as well as business cycle co-movements between the Eurozone and the NMS. This is done using various indicators and several sample periods at both annual and quarterly frequencies to check the sensitivity of results and ensure the robustness of conclusions.

The second approach involves the examination of nominal and real exchange rate (RER) volatility and pursues another important theme in empirical OCA literature. The central part of the variance approach concentrates on the investigation of unexpected variances of RER between respective NMS and the EMU members, which are treated as a group, as well as investigating the RER volatility of selected EMU members before and after 1999.

2. LITERATURE REVIEW

The origins of modern OCA theory can be traced to contributions in seminal papers by Mundell (1961) and McKinnon (1963). In essence, the original concept of the OCA is based on weighing the costs and benefits of giving up exchange rate flexibility, which is understood to be an instrument for dealing with balance of payments (BoP) shocks. If, for example, demand for exports from a particular country falls, a real depreciation might be necessary to maintain the BoP equilibrium and full employment. With a fixed exchange rate, real depreciation has to be
effected by a reduction in money wages, which takes time and causes unemployment. Thus, it is argued that when dealing with shocks to the BoP, exchange rate depreciation and appreciation respectively can reduce the impact on unemployment and inflation, especially in the world of sticky nominal wages. Giving up this important stabilization instrument would only be justified in a homogenous environment with high factor mobility, where shocks are symmetrical and well correlated. In such an environment, the benefits of exchange rate flexibility would no longer be needed, while the benefits of monetary union (MU) could be fully taken advantage of.

The original OCA theory relies heavily on the assumption of stationary expectations of the price level, interest rate and even exchange rate (McKinnon, 2000). Common shocks are thus to be used as a criterion for determining the size of currency areas.

Several years later Mundell (1973) modified his views on OCA, dropping the assumption of stationary expectations and instead focusing on exchange rate uncertainty. While the earlier paper held that asymmetric shocks disqualify regions from being a single currency area, the later paper focused on showing how having one currency could help reduce the effects of such shocks by portfolio diversification and ‘economizing’ on foreign reserves.

This modification is discussed further in a series of papers by McKinnon (recently in McKinnon, 2000), who explicitly criticizes one of the basic assumptions of Mundell’s early work, i.e. the postwar Keynesian belief that national monetary and fiscal policies could successfully fine tune aggregate demand in response to shocks. Giving up this instrument is the central argument against adopting a single currency in the original OCA theory. McKinnon (2000) observes that this opinion was shared even by monetarists such as Milton Friedman, who were fond of Mundell’s earlier case for an independent monetary policy, albeit for a somewhat different reason. They thought that the autonomy of the monetary policy could be the best safeguard of domestic price levels and that a floating exchange rate would naturally reflect the stance of domestic monetary policy. However, the great volatility of exchange rates in the 1970s and the series of currency crises in the 1990s obviously shed new light on the assumption of benefits of floating exchange rates, thus making the original OCA theory somewhat less convincing.

Since the seminal contributions of Mundell and McKinnon in the 1960s, the body of OCA literature has expanded very quickly, most recently due to the interest triggered by the creation of the EMU and its expected enlargement. The vast majority of papers attempt to verify empirically the advisability of forming new or expanding existing single currency areas. In spite of fundamental modifications to the theory by the originator himself (Mundell, 1973) and recent investigations by Ching & Devereux (2000; 2003), almost all of the empirical research is based on Mundell’s early findings (1961). Specifically, the assumption is commonly made that the asymmetry of shocks to which the country (region) is subjected is the main argument against joining MU. Thus, the smaller the asymmetry, the more appropriate the country is considered as a candidate for union. The issue of labor mobility and fiscal transfers as OCA criteria is taken up much less frequently. Frankel & Rose (1998) argue that deciding on the appropriateness of countries’