Optimum currency area theory provides important insights on how the Eurozone might be redesigned

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Optimum currency area theory (OCA) is a body of work that was seen as highly influential by the Eurozone's creators. As **Holly Snaith** *writes, it is often framed as providing a 'checklist' of ideal policies against which – it is usually claimed – the Eurozone does not match up. She argues that the theoretical contribution of OCA is considerably more complicated than this picture suggests. She posits that, depending on which strand of OCA is favoured, entirely different narratives emerge about what the Eurozone is, and how it should be governed.*

Optimum Currency area theory is usually taken to originate with Robert Mundell in a 1961 paper entitled 'A theory of optimum currency areas'. Mundell's central insight was to propose that the territory of a currency need not match up to a nation state in order to be economically effective. The example he provides is of the Americas. He invites us to imagine that rather than a Canadian and an American dollar, we instead have 'East Coast' and 'West Coast' dollars, which better match up with the regionalised production capacities of the two countries. Therefore, when demand for an East Coast product rises, the currency appreciates, rather than stoking a boom in half the country that has to be balanced by depreciation in the other half.

The theory, in its original formulation, is an elegant and simple depiction of a seemingly quite obvious problem: why are currencies tied to economic territories they do not serve? Might a different arrangement be better? It is not difficult to see why this theory appealed to the creators of the Eurozone, and indeed Mundell identified the then-EC as the most likely place to test these ideas, stating that such a currency area was feasible 'only in areas where political organisation is in a state of flux, such as . . . in Western Europe'. Mundell's influence was felt throughout the coming years, culminating in the creation of the euro in 1999 and in the award of the Nobel Prize for economics for him the same year. However, the disarmingly simple problem did not remain simple for very long, but rather raised a number of other, increasingly complex, questions.

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The first of these, quite obviously, was: what defines an optimal currency area? In its simplest terms, it is an area in which the benefits of forming a currency outweigh the costs. But what kind of costs and benefits should we look for? And how should we weight those costs and benefits? The original formulation of OCA took a single global currency to be the starting point, which thus had no transaction costs (indeed, under the Bretton Woods arrangement, this was not so conceptually far-fetched). Originating authors thus considered what the benefits were to slicing currencies up: namely, better autonomy and responsiveness to local conditions. They further suggested that a number of factors ('criteria') would help define what area would be optimal, such as labour and capital mobility, homogeneity, and openness.

But all of these questions are as much political as they are economic, and even the authors operating within these traditions gave very different answers over time. As McKinnon has observed in a 2004 paper, the Mundell of 1961 seemed to envisage a small and homogenous currency area due to the costs of operating a single monetary policy. By 1973 he was in favour of much larger currency unions due to their possible benefits of intensifying trade. Indeed, this is the central paradox of OCA: if we take dynamic benefits to be part of the equation for determining whether a region can be an OCA, then a sub-optimal union can become optimal over time, and the idea of optimality loses much of its meaning.

This, of course, is the kind of paradox politicians can bank on, since it entails that the composition of a currency area might not matter so much as the steps taken to maximise the benefits and minimise the costs. This is the gamble that the creators of the Eurozone took: that by creating a single currency according to political, not economic, boundaries, this convergence could be managed retrospectively. But a central plank of OCA theorists' claims was that an OCA could only minimise the costs of asymmetries – not make them disappear. The less optimal the currency area, the greater the asymmetries – and the greater the number of economic 'losers' created by adjustment. Later authors operating within the OCA tradition (such as Charles Wyplosz) observe the importance of putting fiscal mechanisms in place to ensure that these losers would be compensated as part of a drive for convergence. As the Eurozone crisis has shown, this criterion did not receive much political support.

The crucial point is that interpreting OCA in this way – as providing a 'yes/no' answer to what is, and is not, optimal, but more importantly as a toolkit for managing politically acceptable sub-optimality – is perfectly in keeping with the work of the economists within OCA. Both strands of this debate came to the fore during the 1992 process, where France and Germany argued over how similar countries should be before they were allowed to join the euro. This does not represent a manipulation of an economic debate, but rather a way of drawing on particular interpretations of that debate, such that it justifies a whole array of political choices. And it is one that has clear resonance in the case of the Eurozone, where politicians were clearly enamoured with the possibilities of creating a currency union, but less so by the idea that the choice of participants might be out of their hands.

Regardless of which strand of OCA was taken from this *à la carte* menu, it is clear that the disagreements in OCA theory come primarily from weighting costs versus benefits. And it is impossible to get away from the fact that there are always costs. Having created a large, heterogeneous Eurozone in the hope that retrospective convergence would allow countries to reap the benefits, policy-makers have been left with a currency union that not only implements a (legitimately) selective interpretation of OCA theory, but one that leaves out certain crucial aspects of that theory, such as fiscal compensation. So, is the Eurozone an OCA? On various quantitative criteria, probably not (although it has been more and less so over time), but perhaps this is the wrong question to be asking. The more important conclusion is that it *could* become more optimal, if the political mechanisms were put in place to facilitate it.

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