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Optimal Currency Areas and The Euro

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ABSTRACT: A classic paper on the economics of currency areas illuminates the dilemma facing the eurozone. The recent calm in financial markets does not alter the fundamental problem

"In Mundell's words, 'the validity of the argument for flexible exchange rates... hinges on the closeness with which nations correspond to regions'. Turning this around, one can say the viability of a common currency area is directly related to how well it approximates a single region with the internal mobility of capital and labour"

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The immediate intensity of the euro area's financial crisis has eased in the past year, but as The Economist recently noted, 'europhoria' is distinctly premature.[1] Fundamental economic hardships remain, including unemployment that is above 25% in Greece and Spain, and above 10% in Italy and France.

Colin Lawrence, formerly of the UK's prudential regulator and now with consulting firm EY, recently reminded me of Robert Mundell's seminal 1961 paper, ***A theory of optimal currency areas.***[2] In a concise eight pages – and without a formula in sight – Mundell provides a cogent explanation for the conundrum at the heart of the European single currency.

For purposes of his exposition, Mundell defines a region as an area within which there is mobility of the factors of production, mainly capital and labour, and between which there is factor immobility. He gives a simplified example of two regions initially at full employment, one of which

– region A – produces cars, while the other produces lumber. If there is an increase in demand for cars and a decline in demand for lumber, this will create inflationary pressure in A and increased unemployment in B, assuming institutional constraints on "internal devaluation” (reducing wages and prices) in the latter.

If there is a common currency across these regions, then the situation of A calls for monetary stringency to constrain inflation whereas the situation in B calls for monetary ease to fight unemployment. The monetary authority can prevent inflation in A or unemployment in B, but not both. If A and B have their own currencies, then a flexible exchange rate would allow B to devalue relative to A, effectively reducing the price of lumber and increasing the price of cars. This could re-establish full employment in B without the need for domestic internal inflation in A.

This illustrates Mundell’s main point that “the optimum currency area is the region”. Consider a situation where the east and west of two countries are separate regions with little factor mobility between them. Further assume that cars are produced in the east and lumber in the west of both countries. In this situation, independent currencies for the two countries will not resolve the dilemma. Both countries will face a trade-off between fighting inflation and promoting full employment.

Mundell recognized this argument alone would imply creating a currency for every minor pocket of unemployment arising from labour immobility; an arrangement that clearly defies common sense. Such a situation is unrealistic in a world where currencies are closely tied up with national sovereignty and it would seriously undermine the value of money as a medium of exchange. In Mundell’s words, “the validity of the argument for flexible exchange rates... hinges on the closeness with which nations correspond to regions”.

Turning this around, one can say that the viability of a common currency area is directly related to how well it approximates a single region with the internal mobility of capital and labour.

This line of reasoning has fairly obvious implications for the suitability of the eurozone as a common currency area, particularly when compared to the US. Despite the much talked about regional divisions in the US, it does enjoy the basic solidarity of a nation state. The nationwide dominance of English as a common language, national control of obstacles to inter-state commerce and broadly similar legal systems in most states make internal mobility of both labour and capital much greater in the US than in the eurozone. Furthermore, the significant role of the national government in automatic stabilizers such as unemployment insurance and means-tested income-support payments tends to ameliorate the disparate impact of economic shocks across regions.

Viewed in this light, the contrast with the eurozone is stark. Results of the recent European Parliamentary election underline the lack of trans-European solidarity. Language differences, a patchwork of licensing and professional certification requirements, and the rising political sensitivity to immigration present significant obstacles to labour mobility. The recent controversies sparked by cross- border acquisitions and the defence of national champions pose significant constraints on mobility of capital. All these well-recognised obstacles to mobility of the factors of production make the eurozone a far from optimal currency area. The recent comparative calm in financial markets has done nothing to change this fundamental reality.

1. Beware of europhoria, The Economist, May 10, 2014.
2. Mundell, Robert: A theory of optimal currency areas, The American Economic Review, Vol 51, No. 4, November 1961, pages 509–517. Also reprinted in 100 Years of the American Economic Review: The Top 20 Articles, pages 657–665, available at http://www.aeaweb.org/aer/top20/51.4.657-665.pdf