OPTIMUM CURRENCY AREA:
LESSONS LEARNT FROM RECENT EXPERIENCE *

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Abstract. *The paper discusses contemporary challenges of the theory of optimum currency area. The theory was developed as to define a set of criteria upon which one can decide whether a region will benefit from adopting a common currency. The criteria set is defined as time-variant economic features of the area which jointly makes the area in question better functioning within either fixed or flexible exchange rate. Some areas will properly adjust if linked through fixed rates, or, what is almost the same, with a common currency, while the others will benefit from separate currencies. However, there is a case where the adjustment mechanism fails either way. The paper discusses the treats that might arise when socially beneficial policy is traded-off for short run policy objectives.*

Key Words: *optimum currency area, monetary regime, fixed vs. flexible exchange rate, EMU, Republic of Serbia.*

INTRODUCTION

Optimum currency domain should ensure the minimization of a set of (micro-level) transaction costs and (macro-level) adjustment costs. Considering solely transaction costs, the first best solution inevitably becomes a currency domain as large as possible. However, when considering adjustment costs, the solution ceases to be that trivial. Naturally, academic discussions have focused on the latter part of the cost. According to the prevailing economic theory, an economic area within which economic resources are mobile, with higher degree of trade openness with complementary trade patterns, the area that assembles parts which share mutual compatibilities in matters of economic institutions

and coordination of national policies, benefits if adjusted without being broken up into separate currency areas.

It follows from the above that for a small economy, with closer trade and capital links to a larger currency area, the best way to activate an adjustment mechanism is to abandon monetary independence. For Serbia, some economic features indicate that this is exactly the case. The issue is one of ardent nature since the same arguments shape the right policy choices in terms of exchange rate regime and policy as well as some other related economic policies. The importance of the issue is further reinforced with a strategic orientation of the country to join the EU.

The paper is structured as follows. The first section discusses the theory of optimum currency area, its very roots and the latest evolution. Section two reviews the challenges that question the basic arguments, and particularly applicability of the theory, while the third section analyses what and why both corner solutions, suggested by the theory of optimum currency area, in case of Serbian economic policy went wrong. The final section gives a conclusion.

1. THEORY OF OPTIMUM CURRENCY AREA

The theory of optimum currency area (hereafter OCA) started developing in the early sixties with the path-breaking paper of Mundell (1961), nowadays a Nobel Prize Winner. An influential contribution followed immediately after that, bringing some novelties into the basic idea. However, at that time, currency unions were extremely rare and seen mostly in former colonies, small territories and dominions. After three decades of being placed in the very corner of academic discussions, the appearance of European Monetary Union brings it in the forefront of academic and policymaking debates. This wide and unquestionably important currency union becomes the best real life laboratory for testing the OCA theory, which consequently made the theory vibrant, and constantly enriching with new policy initiatives and responses.

The definition of a currency area is by no means a technical issue. It is "a territory with one or several currencies whose relative values are fixed permanently but whose common external value is determined in markets free from official intervention" (Grubel, 1970, p. 318). For two or more countries to form a joint currency area, it is not necessary to have the same currency as legal tender, but only to give up the independent monetary policy. A currency area exist if it implements simultaneously bipolar exchange rate solutions, hard pegs inside the area (currency boards, dollarization or currency unions) and freely floating regime between the area and the outside world. It is well known that rigid exchange rate (and monetary) regimes rule out monetary independence. As Mundell underlined (2000, p. 285) "fixed exchange rates *always* work *and only work* when intervention in the foreign exchange market determines monetary policy [italics mine]". The author goes on to point out that pegged or pseudo-fixed exchange rates with an independent monetary policy is undoubtedly the worst of all exchange rate systems. It confronts with iron law that an independent monetary policy is incompatible with fixed exchange rates. According to Mundell (2000, p. 283) a fixed exchange rate is a monetary rule oriented to stability goals, while a flexible exchange rate is nothing but "removal of a monetary rule, not a policy in itself".

The theory of optimum currency area is by no means a pure academic but coherent set of ideas that operates on rather high level of abstraction, ignoring many practical issues. For instance, the OCA theory has never been interested in operational differences in the chosen exchange rate regimes. Performances of various rigid regimes are sensitive to those features, which are relevant for the level of commitment. The adoption of single currency or currency substitution is the considered regimes, which are most likely to raise the level of policy-makers commitment to the stability goals. Those regimes are extremely difficult to abandon. It is prohibitively costly to reintroduce one's own money once it was substituted for another country's legal tender. In the case of currency board it is usually necessary to reestablish a central bank in full capacity to have the basic monetary system changed, while in case of an exchange rate peg what is needed is only to change the exchange-rate parity. Therefore, cornered on the same idea, those arrangements may strongly differ in terms of exit strategy.

Basic issues, which are addressed in OCA literature, are the optimal conditions for a set of countries to form a currency union, or for a country to join an existing currency union. Since there are always costs and benefits, the most promising solution is the one that brings the best ratio between the benefits and the costs.

According to Mundell (1961), factor mobility (both capital and labor) and price (and wage) flexibility are the features that might be taken in consideration. The appropriate domain of a currency area is an economic region within which factors are mobile, but between which factors are immobile (Mundell, 1961, p. 661). Even when prices and wages are sticky (downwards), but factors are mobile within an area, any shock, e.g. increase of demand for products from one part of the area in the other part of the same area, will be absorbed automatically. If not, one part of the region will face unemployment, while the other will face inflation. The basic virtue of the floating exchange rate regime, or what is almost the same, division of the region into two separate currency areas, is the possibility to tailor policy response to the specific need. The currency of the first sub-region would appreciate vis-à-vis the currency of the second one, the demand for the first sub-region products will decrease and the external equilibrium will be consequently restored.

McKinnon (1963) built on the previous work by Mundell, and introduced the level of economy's openness as a determinant of OCA. The author's definition of optimality is similar to that of Mundell. Namely, a single currency area is taken to be optimal if the monetary-fiscal policy and flexible exchange rate with the outside world may give the best resolution of the following three objectives: full employment, balanced international position and zero inflation. That way, the exchange rate arrangement is recognized as a mighty adjustment instrument able to address both growth and stability goals, with latter goals covering both external and internal (monetary) stability.

By differing tradable and non-tradable goods, he introduced the ratio (of tradable to non-tradable goods) able to portray the openness. According to McKinnon, a more internationally open economy will be a natural candidate for fixed regimes, since any change in the exchange rate will be offset by internal price-level repercussions with no improvement in the trade balance. Instead, the monetary and fiscal policy can restore the external balance by releasing goods from domestic consumption for export and directly decreasing import. If resources are inter-industry mobile, the adverse effect of spending reduction on the non-tradable sector may be diminished by an increase of production in the tradable sector.

On the contrary, a more closed economy (by definition the one with large internal market), in which non-tradable goods dominate domestic consumption, will benefit from flexible exchange rates, coupled with inflation targeting monetary framework. Any competitive depreciation will increase domestic currency prices of tradable goods, further decreasing import and increasing production of exportable goods and import substitutes, thereby restoring trade balance. This goes with a less damaging effect on the domestic price level, since non-tradable goods dominate domestic consumption.

McKinnon's starting assumption is a balanced foreign trade position. What follows if a country's consumption consists mainly of imported goods and domestically produced non-tradable goods? If import dominates domestic consumption, the country belongs to fixed rate type, since the depreciation of the currency will end up into inflation by activating the pass-through spiral, without immediate comparable positive effects on export. Altering the exchange rate is no longer a viable tool to restore trade balance. It is a conflict since non-tradable sector dominates exportables while at the same time it is dominated by importables. Such a country disfavors both available alternatives. We shall return to this issue in the last section.

Since it appeared, the set of OCA criteria has been continuously reassessed and further developed. Besides the perfect intraregional immigration of labor and unrestrained inflow and outflow of capital funds (Swofford, 2000, p. 122), the contemporary versions of OCA include a wider set of criteria, e.g. mutual compatibilities of the member countries in matters of economic institutions and coordination of national policies, in the complementarity of their trade patterns, business cycle and shock synchronization, etc.

Therefore, the OCA theory implies that some inherent economic features of a country or a region predispose it to be either a fixed or a flexible type follower. However, it is also increasingly recognized that a country's choice of the exchange rate regime may, in return, influence the relevant economic features, making the chosen solution more likely to succeed even if at the time when the choice is made the success looks far more distant. For instance, Karras and Stokes (2001) investigate how two specific criteria, the relative size of output shocks and their synchronization evolute over time for thirteen EU countries. They found clear evidence that the tested OCA criteria are time-variant.

Considering solely trade linkage, Frankel and Rose (2002) tested the performance of rigid arrangements (currency unions and boards) relative to their floating-rate peers, in terms of the level of trade and consequently income, and found the former arrangements outperformed the latter. By holding constant a vast number of geographical and political considerations, the authors found that a currency union triples trade with the partners in question, while at the same time they found no evidence that trade diverts away from nonmembers. Put in that way, the question for a country is not *whether* to join a currency union but rather *when* to join. Nevertheless, a rather frequent shift between the fixed and flexible exchange rate regime seems invariably un-rooted in the theory grounds.

2. CONTEMPORARY CHALLENGES OF OCA THEORY

If a country stabilizes its inflation successfully, its other task ought to be keeping the exchange rate fixed. It is stated in the previous section that a country can "buy" credibility of its monetary policy simply by adapting a currency of a low-inflation anchor country.

Although in very essence the rule appears strong, in the real world it faces challenges. Firstly, it is beneficial to distinguish between what a country claims that it is doing and what it is able to do. Otherwise, the monetary policy would be an easy task. It is a long history of currency turmoil that follows after a break up of a currency peg that teaches us that it is of no use to commit itself to what is beyond one's means.

The above argument against hard peg rests on the idea that the "client" country is not able to follow the path of a chosen "anchor" country. There is a bulk of empirical evidence in recent and far more distant past that supports the practical validity of the argument.

The ultimate success of a stabilization policy that rests on the rigid exchange rate regime depends also on the choice of the "anchor" country. The discipline argument for fixing exchange rates, provided there is a large and stable currency to fix to, is a powerful one. However, "a country should only want to fix its currency to another if that currency were both large and stable" (Mundell, 2000, p. 286). Opposite to the previous one, this argument blames the leading monetary areas of contemporary world, as unable to lead peripheral countries in the right direction.

OCA implicitly assumes that a larger currency area is a better performing one, which is normally a doubtful assumption. Recent developments in the largest economic powers of the world today, primarily the US and the EU, demonstrate clearly that the weakening of growth prospects and undermined economic stability is what one can expect even from the leading economic powers. In what follows, we will discuss in some more details the case of the EU.

2.1. Lessons learnt from recent history of European Monetary Union

Before the European Monetary Union (EMU) was formed, currency unions were extremely rare, and mostly reserved for small economic areas, which deemed prohibitively costly and difficult to take a road to monetary independence. For the fist time in modern history, a set of economies of respectable size has chosen to abandon their national currencies and to form a union.

EMU is an exclusive club of countries that have already undergone political unification. Major changes in legislation concerning different aspects of economic life, particularly labor market, markets for goods and services, etc., were already there, so that high mobility of economic resources is assumed. Unfortunately, even in that field the current stance of matters was far from being ideal. According to Rogoff (2005), EMU failed to achieve the level of its labor market integration and flexibility, and remains far from an optimal currency area.

The conditions for joining EMU are better known as Maastricht criteria. They all serve to assure a smooth process of convergence in the monetary-fiscal area. It is of no surprise that the majority of Maastricht criteria tackle either the fiscal policy itself or what we may call prime outcomes of the fiscal policy. Among the former are the level of governmental deficit and public debt, while the latter includes inflation and interest rates, and to a lesser extent even exchange rate stability.

Just as a reminder, there is a ceiling on the general government deficit to GDP ratio of three percent, a ceiling that forbids the gross general government debt to (annual) GDP ratio to grow above sixty percent. Moreover, long term nominal interest rates on central government debt have to stay within two percent of the average in the three best per-

forming countries in terms of inflation, while the annual inflation rate a year before formal examination are not to break safety zone of 1.5 percent above the average of the three countries with the best inflation record (the lowest level). Simultaneously, a candidate country must prove ability to keep the exchange rate vis-à-vis the Euro stable (there are also precise measurements of it).

They all have little to do with the previously mentioned OCA criteria, since monetary unification is suggested to follow political and fiscal unification. In that respect, EMU is a peculiar invention that assembles monetary unified fiscal independent member countries. Goodhart (1998, p. 424) underlined the fact that he called "divorce between monetary centralization and governmental decentralization … with the main fiscal functions remaining at national level is the source of potential tensions". This lack of readiness of member countries to surrender their fiscal authority made fiscal convergence criteria crucially important to avoid any future clash between monetary and fiscal policy orientations. It happened that the fiscal rules proved to be a weak guarantee that the member states are going to align their fiscal policies. Speaking of fiscal policy related rules, it is worth mentioning that the Maastricht criteria create a framework for candidate countries. However, what really matters for the member states is fiscal adjustment regulative drowning from the Stability and Growth Pact (SGP). The basic virtue of the rules lies in its mechanical nature of implementation. Nevertheless, albeit the Pact calls for fiscal corrections, it excludes the automatic application of the correction procedure. Ironically, its revision in 2005 further diminished it. According to Buiter (2006), the fatal formal weakening of the SGP came from the following modifications:

Firstly, for an offender country it is no longer necessary to prove that "unexpected adverse economic events" are outside the control of it, to avoid fine or costly process of fiscal adjustments. Secondly, instead of previous numerical definition of "severe economic downturn", which may be used as an excuse for breaking the deficit ceiling, the revision introduced rather fuzzy statements, which enable the Member country concerned to report almost any case of slowing down of economic activity as a severe downturn. Having considered those as many other flaws of the procedure desperately needed for successful fiscal adjustments, the author goes on to conclude that EMU formula for tackling excessive deficits is dead.

The latest developments in EMU are persuasive. A common currency and monetary policy did not foster fiscal convergence. Exactly the opposite is true. Prodigal public spending and lack of fiscal discipline undermined the role that a common currency and monetary policy may play.

3. OCA POLICY RELEVANCE FOR SERBIA

The same problems, which nowadays undermine the very prospect of the Euro, undermined the success of our earlier attempts to import stability by anchoring the currency. For the Republic of Serbia, being a small economy with strong trade relations with the EU, the natural choice has to be an exchange rate fixed to the Euro. It is not surprising that in the recent past, as well as nowadays, some academics advocate loudly for currency board (e.g. Fabris, 1999, Galić, 1999, Vuković, 2011). Wanderings in exchange rate policy join the wanderings in academia position. Albeit, de jure we stuck to the same regime during the entire past decade, de facto it has changed several times (Josifidis et al., 2009).

From the very start of the reform, Serbia pegged its currency. From the pure technical point of view, the policy was completely in accordance with the theory recommendation. The money issuing process was solely driven by foreign exchange intervention, with no changes in net domestic assets of the central bank. Because of fiscal expansions and inflation inertia, the policy of anchoring the currency slipped into the unprecedented real appreciation. The automatic adjustment mechanism was out of order. In 2003, the National Bank of Serbia (NBS) introduced repo operations in order to sterilize money growth, but continued to intervene with foreign exchange sales on rather massive scale. The local currency set up for slow but steady nominal depreciation. Unfortunately, in real terms the currency proceeds to gain the value against the Euro, let alone previously accumulated gap in terms of real overvaluation. This policy was abandoned during 2006, when the central monetary authority let market forces determine the exchange rate. Foreign market interventions were less frequent and occasional from both sides. It was then that the monetary strategy shifted from exchange rate targeting to inflation targeting. However, what happened is that domestic inflation neither fully converges with inflation rate in the zone of reference currency, nor that inflation targets were regularly hit (Janković and Stanišić, 2012, p. 401). A stream of capital from abroad followed capital account liberalization, and started driving the exchange rate dynamics. The peculiar coincidence of starting capital liberalization and giving up exchange rate targeting made the monetary policy a less viable tool for restoring external balance. Namely, inflation differential may play a greater role in balancing external position if only trade relations dominate capital relations. Consequently, it happens then that exchange rate exhibits both unprecedented volatility, and for the first time even strong nominal appreciation. Spillover of the global financial crisis in the autumn of 2008 brought back foreign exchange interventions, but the strike was so heavy that the currency depreciation was inevitable.

It seems that both corner solutions were failure. Let us try to look for the common roots of the failure of different exchange rate policies. Firstly, it is inability to align fiscal policy with the stability goals. Rather frequent fiscal breaks colored our recent economic history.

Secondly, no exchange rate policy succeeds to incite the desperately needed foreign trade adjustments. Trade deficit stayed huge and largely immune to changes in the exchange rate policy. As underlined in McKinnon (1963, p. 724) what really matters is resource immobility across industries. Local currency appreciation boosts import and holds export down, while the rest of domestic consumption is filled with non-tradable goods production. However, the reverse fails. The periods of nominal depreciation are not followed by an increase in production of exportable goods as well as import substitutes. A plausible answer of this asymmetric response of quantities to the change of price is a well known fact that quantities (e.g. mobility of resources across industries) need more time to react. Secondly, the adjustment process works well when exportable goods are there, so that changes in exchange rate generate distribution of already produced amount of goods between a part that is consumed domestically and a part that goes to export. When the total amount of exportable goods produced is small (e.g. because of undermined national competitiveness), in order to raise export an economy first needs a reallocation of resources toward industries which produce exportable goods. On the contrary, importable goods are produced partly outside (for a reasonably small country they are abundant) and partly domestically produced (import substitutes). An economy will successfully adjust if currency depreciation substitutes import for domestic production. However, in real world

import is not easily substitutable, for example, because the goods are of specific nature so that they are not domestically produced.

A special scrutiny deserves a conflict between two optimality objectives: balanced international position and inflation. As already mentioned, both objectives belong to stability goals. They are different proxies for economic stability. However, they are different in a peculiar way. A myopic policy maker can ignore unbalanced international position for some, even very long time, especially when there are abundant alternative (but not equally sustainable) sources of international reserves, other than trade surplus. As stated, the different sources are not equally sustainable. They are not even comparable in terms of McKinon's first objective, i.e. full employment.

Let us tell you a parable. Imagine a person who is cleaning snow from the house doorsill by throwing the excess snow on the house roof. One can run out of house faster without the fear of slipping, so that she or he can calmly enjoy winter scenery. However, when enough snow accumulates on the roof, it will fall down crashing the house itself. Therefore, if policy-makers fear that freely floating exchange regime will jeopardize inflation goals, and take the steps to hold back its slippage, they put in danger the very sustainability of country's external position. Ironically, the policy is called stabilizing.

There were earlier attempts to mark the devaluation as damaging since adverse pass-through effect overrides the effects on export recovering (Dragutinović, 2008). But there is certainly little potential of overvalued exchange rate to recover export. The above assessment is backed up by so-called econometric estimations that export reports growth even when currency appreciates (Tasić and Zdravković, 2008). The regularity (if any) masks that existing exporters were raising its export to offset losses occurred from overvalued exchange rate. Nevertheless, export will grow sustainably, and trade will be more balanced, if only there is a stimulus for economic resources to migrate from non-tradable to tradable sectors. When overly beneficial policy is postponed for a long enough time, it is hard to differentiate a cause from an outcome. A pervasive trade deficit surely challenges the ability of monetary policy to hit internal stability goals, but at the same time, it is at least partly an outcome of protracted monetary policy that ignores the overvalued exchange rate.

CONCLUSION

Several questions arise from the above discussion. Firstly, speaking of adjustment mechanism, what works properly in theory, goes hand in hand with serious social sacrifices in real life. Instead of in the blink of an eye, the adjustment mechanism works with long-lasting process of suboptimal growth. Further, growth vs. monetary stability is not one size fits all solution, but rather country-specific and ever-changing choice, which brings complex social interactions and struggle into the policy-making formulae. It undermines the commitment of followers to follow the leader, as well as the commitment of the leader to lead in the right direction.

The OCA adjustment mechanism, which is assumed to work properly when shocks are acute and temporal, will not be an even comparably effective response to chronic fiscal and competitiveness issues. Thus, the more a country needs import of stability from abroad, the more likely it is that it will fail.

Finally, bearing in mind the current level of fiscal issues in Eurozone, as well as undermined economic perspectives of the region, is it the right choice for Serbia to import "stability" from there? Note that the exchange rate that links two equally soft currencies will stay constant as long as they are equally soft. This is another reason for abandoning the Euro as a strong benchmark.

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OPTIMALNO VALUTNO PODRUČJE:
POUKE IZ NEDAVNIH DOGAĐAJA

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U radu razmatramo izazove koje pred teoriju optimalnog valutnog područja donose savremena događanja. Ova teorija je razvijena s ciljem da se definiše skup kriterijuma na osnovu kojih se može odrediti da li će nekom regionu odgovarati uvođenje zajedničke valute. Skup kriterijuma obuhvata promenljive ekonomske odlike područja, koje zajednički određuju da li će neko područje bolje funkcionisati ukoliko ga povezuje neki oblik fiksnog deviznog režima ili upravo suprotno, režim fluktuirajućeg deviznog kursa. Za neke oblasti proces prilagođavanja će biti efikasniji ukoliko se u području uvede neopozivo fiksni devizni kurs, odnosno, zajednička valuta kao suštinski identična opcija, dok će kod drugih oblasti bolje rešenje predstavljati izdvojena valutna područja. Međutim, postoje i slučajevi da mehanizam prilagođavanja ne funkcioniše bez obzira koje od ova dva rešenja se primenjuje. U radu razmatramo rizike koji nastaju kada politiku, koja je društveno efikasna na dugi rok, potisnu kratkoročni ciljevi.

Ključne reči: *optimalno valutno područje, monetarno-valutni režim, fiksni nasuprot fleksibilnom deviznom kursu, EMU, Republika Srbija.*