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Is Europe an Optimum Currency Area?

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Abstract

The debate on EMU has been very influenced by the traditional theory of optimum currency areas (OCAs). The paper shows that this theory is not an ideal yardstick for an assessment of EMU. Its assumptions are not very realistic and its focus on asymmetric real shocks is much too narrow. In addition, observed past real exchange rate changes are not a good predictor of future real shocks in the European Union (EU). In general, the OCA approach is heavily biased towards very small currency areas. Because of these shortcomings the paper develops a monetary approach to the theory of OCAs. In this concept the choice between a monetary union and independent national currency areas is analysed from the perspective of monetary policy efficiency. It can be shown that EMU is superior to national currency areas in terms of credibility, the response to asymmetric monetary shocks and the effectiveness of monetary targets and instruments.

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