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Optimum Currency Area and Eurozone

Introduction

The world contains different countries, with some using their currency and others sharing. Therefore, the use of currency dates back in history when nations attached their money to an international standard, including gold and the United States dollar. Thus, this limited making money that can affect prices, output, and government revenue. However, nations have preserved their currencies. The question that arises here is what could be the impacts when the world uses the same money? Using one coin could mean that the transaction cost associated with international finance would be removed because the exchange always needs some conversion rate and the variation in the value of different currencies.

Moreover, the European Monetary System unveiling resulted in most of the money utilized in the European nations securing their exchange rates everywhere in the central equality referred to as the European Currency Unit (ECU). Therefore, this made the discussion occur concerning if Europe has become an optimal currency area. The optimal currency area is where countries use the same currency to create a substantial economic advantage (Bützer 127). by 1990 the Euro was introduced, and all nations participating in the Exchange Rate Mechanism changed their state currency to the shared European currency. This proposal explores the

attributes of Optimum Currency Areas (OCA) by explaining the theory's theoretical background and connecting with the Eurozone to know if it is part of the OCA.

Optimal Currency Area Theory

The concept of OCA was theorized by Robert Mundell back in the 1960s. Therefore, OCA was the region where one currency would yield the highest economic benefit (Bützer 128). Similarly, another source by von Furstenberg stated that OCA is an ideal environmental realm of one money of various currencies whose conversation rates are irreversibly static and can be combined (120). Furthermore, the external shared value is realized on the foreign conversion market unconstrained from a sanctioned financial intervention. Similarly, the optimality in the situation of the money regions is where various features of the currency zones lead to increased welfare of the people benefiting more than when the countries were using different currencies.

Nations that have a typical economic relationship can benefit from using parallel currency. Therefore, this permits them to have a closer integration of capital markets and enable trade. Also, a large existing and unified labor market ensures employees can move to the currency zones freely and effectively and reduce unemployment in the regions. On the other hand, OCA has a defect because the countries in the zone cannot change the fiscal or financial policies or implement interventions to alleviate their economies. OCA has several properties that it supports, which significantly benefits all the countries within the area.

The first property is the mobility of labor. The currency region that meets this feature has the potential of not being required to change the actual factor prices. Therefore, it is recognized that the mobility factors lead to the most significant distribution in a free trade zone, thus improving the region's welfare. Furthermore, the OCA is the labor flexible and other factors of

production such as capital since it is realized by the rate at which the investment is offered to one nation and taken by the other country. Consequently, facilitating labor flexibility reduces administrative barriers, including issuing visa-free travel, institutional limitations such as boundaries on transfers of pensions or benefits, and cultural restrictions such as language variations.

Another property is price and wage elasticity. The flexibility in prices of goods and services and wages for workers is critical for OCA in the short run, especially when there is a need to change procedures that comprise issues that can reduce shock in the economy. For instance, when the prices and wages in the same currency region are supple, the modification procedure will not lead to continual joblessness in one nation and increase prices in the other (Aizenman 374). Consequently, this will reduce the need for an exchange rate variation, and when the costs and wages are inflexible, suppleness can be attained by using exchange rates. Thus, this will ensure that capital and labor flows among the nations in zone based on the market forces of supply and demand to allocate the effects of economic shocks.

Monetary market incorporation is another essential property of OCA because it ensures an integrated finance market. When countries use one current, they reduce the need for exchange rate changes; thus, only a limited variation in the interest rate will result in capital movement within the nations before the equilibrium is achieved. Also, currency risk-sharing necessitates transferring money to areas that have economic challenges from those with excesses. Other important integration properties for OCA are fiscal and political. The fiscal combination will play a vital role in decreasing the exchange rate changes when a shock has happened because it will help the area when the economic shock hits it. On the other hand, political integration will comprise the pledge to create financial rules, a shared fiscal law, and a robust institutional

connection (Aizenman 376). similarly, an effective currency region requires a prudent degree of compatibility in partialities towards development and joblessness and a substantial capacity by policymakers to trade off the goals.

Moreover, countries in OCA have economic sincerity because of how quickly the international prices travel on the domestic financial position. Therefore, the exchange rate will not be much essential in the modification process. Also, the same business cycle influences the regular ups and downs that are synchronic within the nations in the zone are vital because the central bank within the OCA will create and execute financial policies that focus on dealing with economic recessions and inflations.

OCA has another economic property that is broadening in production and consumption. Since many countries are involved in the zone, there is more diversification, decreasing the need for trade fluctuations because of the exchange rates. Similarly, when governments have a diversified production and restricted specialization and division of labor within them, there will be a decrease in the possibility of asymmetric economic shocks (Gabauer 100680). nations that are profoundly specialized in products that others do not create or manufacture will be susceptible to asymmetric economic shocks; hence, they may not be appropriate for OCA members. The use of diversified production is in battle with some of the already mentioned properties because the more unification within nations economies, and more they will specialize in their jobs and industries. Finally, is a resemblance in inflation rates because it is anticipated that OCA nations have the same or comparable inflation rates (Aizenman 375). thus, when inflation rates of the nation in the same currency region unite, the terms of trade will also be unified. Consequently, this will weaken the need for exchange rate modification since the balanced current account transactions. The currency region that meets all these properties

becomes an OCA because the ideal restricting from the contentment of these features of the currency areas completing with the procedure of welfare development indicates that the benefits from the financial integration surpass the cost.

Eurozone

The European Union was proposed in 1950 by Robert Schuman. This was the foundation of what would later result in a significant partisan, social and economic incorporation. The purpose of forming the European Union was to enhance peace and create a unified economic and financial system (Lehner and Fabio 46). Therefore, this encouraged inclusion and dealing with discernment as well as eliminating barriers to trade and borders. Furthermore, by 1951, the treaty of Paris was signed. This brought up the European Coal and Steel Community (ECSC), which allowed the western European nations to work together by connecting their steel and coal production to stop any country from developing weapons to support upcoming fights.

Nevertheless, after sixty years of the steel and coal establishment, the industry extended and progressed into a single market because of the elimination of commercial, cultural, and partisan barriers among the nations. Thus, the majority of the countries in the European continent were working together. By 2011 the entire European Union's gross domestic product was 12.6 trillion Euros; this was the highest GDP for a single economic unit globally. The Eurozone provided more than seventy-five percent of it (Guiso et al. 122). The partisan and commercial incorporation procedure of Eurozone has resulted in the quickest integration to be realized in the first decade of the 21st century.

Moreover, in 1993 the union went further into implementing the Maastricht Treaty, which created the path for use of the Euro. The euro usage started in 1999 and the flow of the

notes and coins in 2002. Similarly, according to the European Central Bank, the Maastricht treaty formed the ground for the European Union because it was the outcome of several communications between administrations (Barth and Patrick 217). The same source claimed that the treaty created the European Union because it enhanced cooperation between European nations in different ways. The first way is to improve the citizenship process by introducing European citizenship, which permits residents to live in and move without restrictions among the member countries.

Another way is to create a shared foreign and security policy to protect the union's collective values, essential welfares, and freedom. Also, the treaty was signed by twelve nations in 1992. Since the treaty was sanctioned in every nation's parliament through referendums, it was legitimately recognized in 1993. Since then, more nations have joined the union and implemented the laws; currently, twenty-seven countries have left the United Kingdom (Lehner and Fabio 54).

Maastricht Treaty created the groundwork for the Euro as the only currency for Europeans. Therefore, the treaty managed to create the European Central Bank and how the system will work together with the objectives. The central bank's primary goal is to uphold price stability by protecting the value of the Euro (Guiso et al. 108). consequently, the treaty created three stages. The first was to bring the free movement of capital among the member nations; the second was to enhance cooperation within the national central banks and improve commercial policies within the member nations. The final stage is the steady introduction of the Euro with the execution of one financial currency policy where the Central bank was accountable.

Joining the Eurozone was not a walk in the park because the treaty had created laws on how Euro would operate and what nation needs to be in the zone. The criteria are developed to

guarantee price stability and preserve the euro region despite new countries joining. The requirements are critical in ensuring a similarity in the nations' economies to stop any form of regional economic shocks that might make the currency system not work (Lehner and Fabio 49). the constancy and development agreement was planned to ensure a union and guarantee price flexibility and financial accountability among the member states.

The laws developed by the treaty ensure that all the nations that have joined are flexible in four different parts. The first is to control inflation by providing that the nation's average price of goods and services does not exceed the inflation rate of the three best performing European Union member nations by over one point five percent within one year of the observation phase (Guiso et al. 98). The second part is to check the level of public debt by ensuring that the nation's yearly monetary deficit should not be more than three percent of gross domestic product. The general administrative obligation should not be over sixty percent of the GDP.

The third part is to check on the nation's long-term interest rates to ensure it does not increase to more than the three best-performing member countries by over two percent within one year. The final critical part is to preserve the flexibility of the exchange rate by ensuring that it remains within the variation limits offered by the exchange rate mechanism for a minimum of the past two years (Guiso et al. 111). the same source added that for almost a decade after the Euro was put into practice, the member states in the Eurozone relished the low-interest rates, flexible development, and close interstate partisan harmony. Nevertheless, when the 2007-2008 monetary crisis occurred, the European markets became vulnerable to uncertainties of independent debt evasions, high-interest rates, and large banks and nations shook on the edge of the financial downfall.

The Eurozone as an OCA

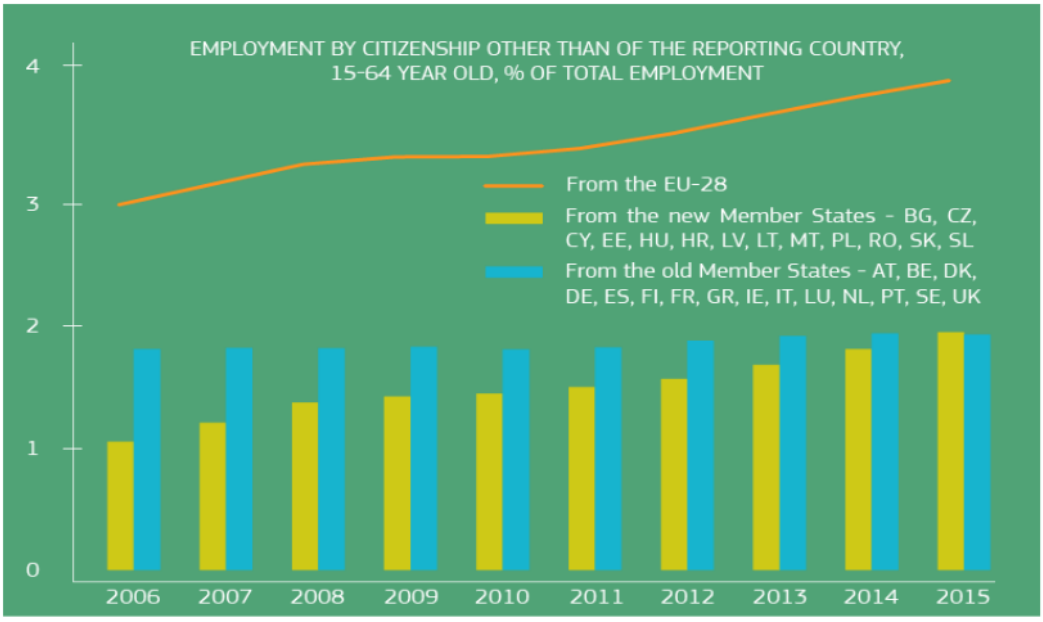
Using the same currency was observed in the signing of the Maastricht treaty, which indicated a significant step in ensuring the European Union attains full economic integration and an inclusive market. Therefore, with the two essential phases in bringing on the Euro as a single currency in 1999 and 2002, the eurozone countries moved close to attaining economic incorporation using a standard exchange rate and accepting to designate all debts un euros. This created a bigger commercial unification of a currency region globally since the integration of the United States into a fiscal union using the dollar.

Nonetheless, using one currency among nations does not make commercial symmetry and incorporation, nor does it signify general and unlimited economic and partisan congruence. Therefore, to understand the financial integration in Europe, it is vital to refer to Mundell's work on the theory of OCA. Mundell emphasized an equilibrium needed to resolve if it is good or not to have a common currency founded on the costs and advantages of elaborated with the choice and the impacts of a financial union (Aizenman 374). several research studies have been conducted to recognize if economic integration results in the achievement of the OCA. Therefore, the studies focus on the circumstances when a country solves its conversion amount to the leading trading companion in developing a cash region.

Financial integration in the OCA model in Europe started in 1979 with the development of EMS. When a member nation of the European Community irreversibly fixed the exchange rates of their money to the central uniformity signified through the imaginary European money. Several efforts are made to check if the European Monetary System is an OCA; nevertheless, the actual problem was presented after 1999. For instance, Bützer claimed that the initial EMU increased the debate on whether using one currency groups the free forces that result to Euro region nations be closer.

Moreover, another study conducted extensive research to investigate the OCA theory dedicating a substantial part to the Eurozone (Markakis 494). the same source concluded several vital conclusions, such as the explanation that the labor mobility, price, and wage suppleness within the European nations are low. Furthermore, the European Commission report supports this conclusion by stating that the suppleness is hindered by the slow achievement of one market and by the sluggishness of disabling several non-tariff blockades (Baimbridge and Philip 7). thus, the wages are slightly inflexible in most nations; the labor movement is low and inspired by other influences and not an economic shock.

The graph below indicates that labor flexibility is an issue in the Eurozone nations because of the slow labor movement. According to the European Commission, the cross-border labor movement can be helpful in a country in regulating the shock. Therefore, since the share of euro employees working in another member nation has augmented over the last decade, the condition varies from one country to the other. Euro employees working in other affiliate nation has intensified gradually; for instance, by 2015, the individuals from new member nations were more than the number of people from the old countries. Generally, there was a small strike during the crisis. Therefore, in the situation of an asymmetric shock occurring in one of the member home nations, the cross-border employees can take part in that shock using their income from other countries abroad. Nevertheless, there will be a slight discrepancy within the member nations concerning the share of cross-border labor from another European Union member nation.



Source: European Commission

Another study concentrated on understanding if Eurozone is an OCA. Therefore, the study utilized the initial members of the EMU and added Greece despite it joining in 2001. Following the theory of OCA, which states that the interest rate convergence will occur in the member nations, the study used the first countries in the union to check if this had happened (Stafsing and Carl 16). Also, the author restricted the analysis using the data between 2011 and 2020 and did not want to use data from the 2008 economic recession. The examination was conducted from the equity indices and result from each nation's ten-year administrative bond. The equity indices and bonds data obtained are indicated in the table below.

	Germany	France	Belgium	Austria	Finland	The Netherlands
Equity Index	DAX 30	CAC 40	BEL 20	ATX	OMX Helsinki 25	AEX
Government bonds	10-year yield	10-year yield	10-year yield	10-year yield	10-year yield	10-year yield

	Italy	Spain	Greece	Portugal	Ireland
Equity Index	FTSE/MIB	IBEX 35	FTSE/Athex Large cap	PSI 20	ISEQ 20
Government bonds	10-year yield	10-year yield	10-year yield	10-year yield	10-year yield

Source: Stafsing and Carl p.20

None of the securities are affected substantially by the ECB variation in the deposit facility rate from the study. Therefore, Staffing and Carl claimed that the Eurozone is an OCA, although not all data was present (17). The conclusion is developed based on the European meeting of various macro variables, such as inflation rate and flexible exchange rate levels before the nation has been included in the fiscal union. Similarly, the argument concerns whether the Eurozone is OCA by focusing on the securities matches with the financial policy announcement. Nevertheless, this conclusion is derived by looking at one property of the OCA and not all. For instance, because the interest rates in the market are already joined, it is reasonable for them to respond in all nations. Thus, based on Mundell's second model, the risk-sharing and international portfolio diversification match the results.

Every European member nation needs to satisfy a specific criterion to be in the Eurozone. The requirements must continue to be respected even after the countries have been accepted in the Eurozone. Although some of these critical elements have already been explained, the important ones are exchange rate, price flexibility, and long-term interest rates. The countries need to ensure they do not devalue their money (Aizenman 376). therefore, this was made outdated with the switch to the Euro for nations in the Eurozone. Furthermore, the member countries must have been engaged in the exchange rate instrument under the EMS for two successive years before the analysis without severe strains.

There is no level of partisan union that can force economic unification by fiat, and one currency does not cause commercial convergence. Nevertheless, most of the Eurozone's retail coalition thus has significantly comprised of following the incorporation of the law into one currency region, missing the vast and extensive policy equipment to develop and substitute macroeconomic convergence between member nations. More information is emphasized on the high economic openness of every European government and the increased diversification in production (von Furstenberg 123). similarly, although the trade augmented beyond the intro of the Euro, countries that will unite with the euro region in the coming days will gratify the properties even if they developed OCA with the Eurozone before.

Conclusion

The proposal will understand the Optimum Currency Area, including the conditions that define a region as optimal. Also, it will determine the Eurozone and explain if it is an OCA. OCA is the geopolitical region where one and integrated currency is utilized and offers the best equilibrium in the economies of scale to money and efficiency of a macroeconomic policy to enhance development and flexibility. Nevertheless, the concept of OCA was established and initially outlined by Robert Mendell, an economist, according to the range of incorporation and resemblance among the economies. Eurozone as an OCA is a question under debate. Thus, for it to be an optimal currency region, it needs to ensure the welfare of the nations involved in EMU is improved after their financial incorporation under the standard money, which is the Euro. Similarly, several factors are under deliberation when measuring the ideal of the currency region, including labor flexibility, wage suppleness, financial incorporation, inflation union, and trade augmentation.

Moreover, the research exploration concentrated on using past studies to discover their evaluation of the present economic data concerning the Eurozone. The studies conclude that inflation convergence and financial integration are substantially improved through the money market and bonds, particularly in the past decade. Also, the zone has worked to improve the trade strengthening with the euro region nations, which improved almost a third, and the diversification of production, which has perfectly enhanced benefits among the member countries. Nevertheless, the Eurozone has low labor movement. The wages are inflexible; therefore, the Euro is not one of the OCA because more effort is required in many properties to ensure optimal every criterion.

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