REVIEW ARTICLE

# "Optimum Currency Area" in the Balkan Region

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## Abstract

In economics, an "Optimum Currency Area", also known as an optimal currency region (OCR), is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency. It describes the optimal characteristics for the merger of currencies or the creation of a new currency. The theory is used often to argue whether or not a certain region is ready to become a currency union, one of the final stages in economic integration. Over time, step by step, is expected to join the EU Albania too. In a continuous and closer integration there's a question if would have been profitable whether our country can adopt a common currency (Euro), as many countries did in the EU, or is better to follow another example that stops a further integration after EU membership, like (United Kingdom, Sweden, etc.).

It is Euro the right choice as a common currency for the EU? What are the criteria for an Optimum Currency Area? Do have different countries profitability with different levels of wealth, different populations and diversified products, adopting the samecurrencyor not? Through thetheoryof"Optimal CurrencyArea" elaborated by RobertMundell, Ronald Mc Kinnon and Peter Kenneth,will beanalyzed notonly if Europe is one of the Optimal Currency Area.It will be also analyzed whether the Balkan countries, divided byethnic, historical and cultural reasons, will have benefits from a common currency or at the opposite, a common currency would slow down their economic growth.

**Keywords**: Optimum Currency Area, Currency Union, Region, Balkan, Economic Growth.

## 1. Introduction

In economics, an optimum currency area (OCA), is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency.

It describes the optimal characteristics for the merger of currencies or the creation of a new currency. The theory is used often to argue whether or not a certain region is ready to become a currency union, one of the final stages in economic integration.

An optimal currency area is often larger than a country. For instance, part of the rationale behind the creation of the euro is that the individual countries of Europe do not each form an optimal currency area, but that Europe as a whole does form an optimal currency area. The creation of the euro is often cited because it provides the most modern and largest-scale case study of the engineering of an optimum currency area, and provides a comparative before-and-after model by which to test the principles of the theory.

In theory, an optimal currency area could also be smaller than a country. Some economists have argued that the United States, for example, has some regions that do not fit into an optimal currency area with the rest of the country.

The theory of the optimal currency area was pioneered by economist Robert Mundell.

Europe exemplifies a situation unfavourable to a common currency. It is composed of separate nations, speaking different languages, with different customs, and having citizens feeling far greater loyalty and attachment to their own country than to a common market or to the idea of Europe.

The benefits and issues about the optimal currency area.

To be within a space of countries that adopted the same currency, contains a number of opportunities for each country as well as some problems. The positive elements begins with:

1. The project transaction costs.

Exporter and importer clients are not obliged to negotiate in which currency they must make payments. It is going to be decided often whether the payment should be paid in the currency of the exporting country or in the currency of the importing country. In other cases is choosen a third currency to carry out these payments. Example, the trade between Albania and Macedonia, would not be in ALL or dinar but in euro or US dollar. To have the same currency means to have zero project transaction costs, not allowing profit margins for financial intermediaries and increasing the competitiveness of the exporting enterprises. In this case the small and medium enterprises are enhaced to take part in export activities without the need of financial experts.

1.2. Exchange rate

When exports are priced in the currency of the exporting firms, importing firms do not know exactly how it will be when the exchange rate will have to carry out the payment of imported goods and vice versa. The party that is facing with the financial risk of exchange rate may be provided by means of forward contracts but this raises costs and inhibits trade. The elimination of exchange rate also facilitates foreign direct investment, transfer of technology and effective production structures, not forgetting the fact that a country with a little used currency , with a high volatility scares foreign investors.

1. 3. Quality of monetary policy.

To take part into a monetary union means to lose the national monetary policy autonomy, which is exercised by the Central Bank. The replacement of this bank by another one, which is essentially composed by the best experts of monetary policies will significantly increase the quality of the management of monetary policy. A common central bank is unlikely to finance governments budget deficits and more likely to maintain a substantial independence on specific governments.

The problems of the existence of an optimum currency area will be linked to the central bank's inaction shocks or economic crises, local and sectoral internationally known as asymmetric shock. If we assume the decline of the export of a country for reasons of price or competition, this event would enforce the country's trade deficit. The best option would be, for the local currency, a depreciation versus foreigners to make their exports competitive again, but this thing is possible if the country has his own currency. The only option will remain the reduction of wages that will cause a reduction of prices that will allow once again the competiotion of products. This alternative would cause an economic recession that could be long.

The situation may worsen when the effects on different countries of the monetary union can be asymmetrical, although the shock may be symmetric. That because the structure of production may change, regulations in labour market, financial sector, the level of debt etc.. .The situation could be more complicated when the Central Bank through the monetary policy reacts to a symmetric shock causing asymmetric effects to the different countries that compose the common monetary zone.

Another issue is related with the coordination of the Central Bank policy. Some may prefer as a primary mission of the central bank striving to promote economic growth and being less concerned about price increases while other countries consider low inflation as the initial and final target in the implementation of monetary policy.

**2. Methods**

Optimal Currency Area criteria

OCA theory, defines six criteria for the formation of an optimal currency area. Three of these criteria are economic, while the other three belong to political decision.

Three necessary economic elements are:

1. Circulation of the workforce. This criterion was proposed by Robert Mundell, who suggested that the costs of a country, which is part of a monetary union may be eliminated if capital and working factor too can circulate quickly and smoothly between countries. This feature is actually quite problematic because the transfer of people in everyday life requires time and is hampered by different factors. Migrants should consider elements such as relocation costs, loss of work in the country of origin and finding another job, career opportunities, stabilization opportunity for wives, children and relatives, social benefits, health schemes, pension, taxes on income from work and savings, language, religion, traditions, racism and xenophobia in the host country, weakening of family ties and feelings of patriotism to the country of origin.

2. The diversification of production. Peter Kenen explains that countries into a monetary union must have a certain level of diversification of production. It is likely that more countries that are affected by

asymmetric shocks are those that are specialized in the production of a limited number of goods and services. In contrast, countries with similar economic structures and with diversified products and exports, can naturally create an Optimum Currency Area.

3. The opening of the economy. Ronald Mc. Kinnon explains that today most of the goods are produced in different countries of the world. Commercial competition brings a unification of their price and makes these independent towards the exchange rate. Exchange rate as a result does not affect competition because the prices are often global. When the economy is small and open to trade is unlikely to change the price of products and the renouncement of the exchange rate and monetary sovereignty has not particularly high costs for countries, at least when crises are temporary and moderate. The countries with an open economy which trades more and more with each other can form an Optimal Currency Area.

- Fiscal transfers. This term means that the countries which form an OCA agree to compensate each other in case of asymmetric shocks. Region hit by a sectoral crisis is expected to be offset by another that had benefits. In practice this theory and this condition is very difficult to implement. A driver can be more casual at the wheel if the insurance companies will pay all the damage tha will be caused. In practice happens that are usually the same areas hit by the crisis. The safe areas can protest for continuous compensations to troubled areas.

- Similar preferences. Asymmetric shock is not a problem until countries agree on an equally and common responsiveness. The problem lies in the fact that the shock does not show the same effect in different countries and therefore preferences fot the answeres to be given vary.

- Solidarity. The criterion of solidarity is purely political. Shocks even when are symmetrical, create contradictions regarding the proper response. When various countries of a monetary union create conflicts regarding their own national interests, they must accept some cost with the goal of a common future. Mutual solidarity should rule over local nationalisms and local selfishness.

3. Analysis

Is Europe an optimal area Currency?

Results are not clear, the tests have a mixed criteria.

| Criteria | Fulfilled? |
|---|---|
| i. Mobility of the workforce | Not |
| ii. Opening of economy | Yes |
| iii. Diversification | Yes |
| iv. Fiscal Transfer | Not |
| v. Common solutions | Partial |
| vi. Solidarity | Partial |

i. Labor mobility in Europe is relatively low and is not expected any particular evolution in the future. Unlike the United States of America where 2.5% of workers move from state to state every year, in Europe this figure is reduced to 0.2%. The reason of a small movement of labor force is explained by the fact that unlike the US many languages spoken in the Eurozone, and the majority of the workforce knows a little number of languages. Traditions, racism, family and social connections, slow down and harden nationalist feelings of the labor force movement. To conclude the bureaucratic level of integration and unification of services is lower levels compared to the US.

ii. The opening of the economy. Most European countries have a very dense trade exchanges between them, more than 70% of import-exports, indicating a high level of economic integration. In addition, on the vast majority of the Eurozone, the sum amount of import and export is significantly higher than the rate of 80% to GDP. This definition is significant to identify open economies.

iii. The Diversification of the economy measures the change in the structure of trade flows and the value added structure of a country against other countries, members of an optimal currency area. In the case of EU countries too have clearly a structure that creates value added through services so dominant, followed by industrial activities, leaving at the bottom agricultural production. Nearly all Eurozone countries are in the process of creating value by Service Sector or in the third phase, under division eras made by Fourastié.

iv. Political criteria of fiscal transfers in general remains unfulfilled, as the whole EU budget is around 1% of GDP of the member states. Besides the institutional costs of these funds allocated to common agricultural policy and infrastructure funds that are shared to the poorest regions, whether or not these have been hit by an economic crisis. Do not exsist

nowadays compensation methods among countries which are hit by asymmetric shocks.

v. Joint solutions. The European countries have not demonstrated similar preferences in the field of preferences on policies to be taken. Germany is committed against inflation, while Italy historicaly helped the competitiveness of its products through the currency depreciation. With the new currency, the European Central Bank had the prerogatives to set course , but the perceptions of lobby-s such as political parties, trade unions, civil society in different countries bring support and criticism elsewhere.

vi. Solidarity. It is very difficult to explain if in Europe won solidarity strategy against the local interests. On one hand, the assistance that countries like Germany has provided to other Eurozone countries underscores the element of solidarity but on the other hand the tolerance is partial. On average only 16% of european residents say they feel European. The rest declares that they rarely feels European but often identify themselves with the name of the county.

Would be an Optimal Currency Area the South Eastern Balcans?

| Criteria | Fulfilled? |
|---|---|
| i. Mobility of the workforce | Not |
| ii. Opening of economy | Yes |
| iii. Diversification | Not |
| iv. Fiscal Transfer | Not |
| v. Common solutions | Not |
| vi. Solidarity | Not |

i. Mobility of the workforce. As we know, the Western Balkan countries are characterized by significant changes in the ethnic, religious, linguistic, cultural. Their level of wealth (or poverty) is similar but, frequent wars and political and ethnic conflicts, in peace time too made practically impossible the chance for laborforce exchange between Western Balkan countries. If we add the fact that the rules and administrative systems are affected by a higher bureaucracy, the access to migration within these spaces would be almost unenforceable.

ii. Opening Economy. Virtually all Western Balkan countries, without Kosovo, could be considered as open economies, because the amount of goods and services imported and exported exceeds

80% of GDP. As we can see in the table nr 1,2,3 and figure nr 1.

**Table 1**. Exports of goods and services

| Country Name | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Albania | 28,8 | 29,6 | 29,6 | 32,4 | 34,0 | 33,3 | 35,1 |
| Bosnia and Herzegovina | 26,4 | 26,2 | 24,7 | 29,1 | 31,1 | 30,9 | 32,0 |
| Kosovo | 16,0 | 15,7 | 17,1 | 19,9 | 19,6 | 18,2 | 17,4 |
| Macedonia, FYR | 52,4 | 50,9 | 39,2 | 46,6 | 54,9 | 53,6 | 53,9 |
| Montenegro | 44,4 | 39,5 | 32,1 | 34,7 | 42,8 | 44,1 | 41,8 |
| Serbia | 28,4 | 29,1 | 26,8 | 32,9 | 34,0 | 36,9 | 40,8 |
| European Union | 37,9 | 38,5 | 34,3 | 37,8 | 40,4 | 41,4 | 41,5 |

Source: World Bank

**Table 2.** Imports of goods and services

| Country Name | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Albania | 55,0 | 55,4 | 53,8 | 53,0 | 56,7 | 51,9 | 52,9 |
| Bosnia and Herzegovina | 55,4 | 59,4 | 48,9 | 51,1 | 55,3 | 55,2 | 53,1 |
| Kosovo | 52,2 | 54,3 | 52,0 | 55,5 | 56,8 | 52,4 | 49,0 |
| Macedonia, FYR | 70,8 | 75,2 | 61,0 | 65,3 | 74,5 | 76,3 | 72,8 |
| Montenegro | 85,7 | 94,0 | 65,4 | 63,1 | 64,9 | 68,8 | 62,1 |
| Serbia | 52,7 | 54,1 | 42,7 | 47,9 | 49,4 | 53,6 | 51,9 |
| European Union | 37,1 | 38,2 | 33,3 | 37,0 | 39,5 | 39,5 | 39,0 |

Source: World Bank

**Table 3**. Imports and Exports og goods and services

| Country Name | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Albania | 83,8 | 85,0 | 83,4 | 85,5 | 90,8 | 85,2 | 87,9 |
| Bosnia and Herzegovina | 82,8 | 85,6 | 73,6 | 80,2 | 86,4 | 86,1 | 85,0 |
| Kosovo | 68,2 | 69,9 | 69,0 | 75,4 | 76,4 | 70,6 | 66,4 |
| Macedonia, FYR | 123,2 | 127,1 | 100,2 | 111,8 | 129,3 | 129,9 | 126,7 |
| Montenegro | 131,1 | 133,5 | 97,5 | 97,8 | 107,7 | 112,9 | 103,9 |
| Serbia | 81,0 | 83,3 | 69,6 | 80,9 | 83,3 | 90,5 | 92,7 |
| European Union | 75,0 | 76,7 | 67,7 | 74,8 | 79,9 | 80,9 | 80,5 |

**Source**: World Bank
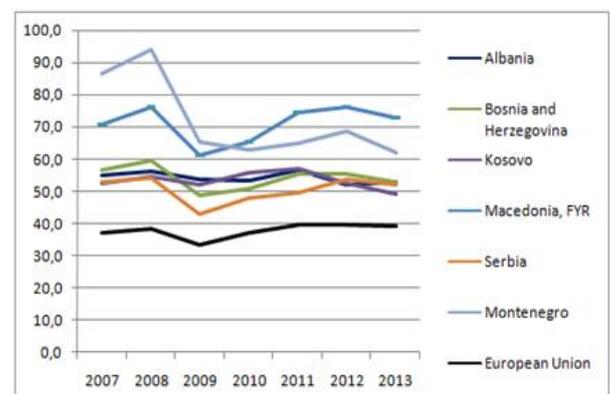


**Figure 1.** Imports and Exports

The grey side of trade Balcan countries consist in the fact that the economic exchange between them is very weak. Instead the major trading exchanges are precisely with the countries of the EU and the

Eurozone, while regional trade includes neither a tenth of the total trade.

iii. Diversification is a criterion which is completed in a partial way between Western Balkan economies. Regarding the added value produced by the agriculture, there is a range of variation from 22.2% of total GDP for Albania to 8.5% for Bosnia. At the same time the Value Added of the agricultural sector in the European Union is just 1.7% of GDP. In industrial activity too, there are significant fluctuations. Albania is an example of a country with a little industrial production, only 15.3% of GDP, while Serbia produces 29.8% of GDP through industrial activities. Into the EU countries this rate is 24% of GDP on the average. Through the Service Sector, European Union produces 3/4 of GDP, while the country with the highest contribution in the Balkans is Bosnia with 64% of GDP, while Kosovo is the country where service activities provide only 56% of GDP. This criterion too does clearly not met by the Western Balkan countries.

**Table 4**. Agriculture Value Added

| Country Name | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Albania | 20,7 | 19,4 | 19,4 | 20,7 | 21,0 | 21,8 | 22,2 |
| Bosnia and Herzegovina | 10,0 | 9,1 | 8,7 | 8,4 | 8,4 | 7,7 | 8,5 |
| Kosovo | 15,8 | 15,0 | 15,1 | 17,0 | 17,4 | 14,8 | 15,0 |
| Macedonia, FYR | 10,6 | 11,6 | 11,2 | 11,5 | 10,9 | 10,4 | 10,4 |
| Serbia | 10,0 | 10,3 | 9,6 | 10,2 | 10,7 | 9,0 | 9,4 |
| European Union | 1,6 | 1,6 | 1,4 | 1,6 | 1,6 | 1,6 | 1,7 |

**Source**: World Bank

**Table 5.** Industrial Value Added

| Country Name | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Albania | 15,0 | 18,5 | 11,6 | 14,3 | 14,3 | 14,4 | 15,3 |
| Bosnia and Herzegovina | 27,9 | 28,3 | 27,9 | 27,6 | 27,3 | 25,6 | 27,1 |
| Kosovo | 26,0 | 26,6 | 28,4 | 27,5 | 26,4 | 23,7 | 29,1 |
| Macedonia, FYR | 31,0 | 29,3 | 27,5 | 27,7 | 29,1 | 25,4 | 26,2 |
| Serbia | 28,3 | 28,7 | 28,7 | 28,4 | 29,5 | 30,3 | 29,8 |
| European Union | 26,4 | 26,0 | 24,5 | 24,8 | 24,8 | 24,5 | 24,3 |

**Table 6**. Services Value Added

| Country Name | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Albania | 60,4 | 62,1 | 69,0 | 65,0 | 64,8 | 63,7 | 62,5 |
| Bosnia and Herzegovina | 62,2 | 62,0 | 63,4 | 64,0 | 64,3 | 65,7 | 64,4 |
| Kosovo | 58,2 | 58,3 | 56,5 | 55,5 | 56,2 | 55,5 | 55,8 |
| Macedonia, FYR | 58,5 | 58,7 | 61,4 | 60,8 | 60,0 | 64,3 | 63,4 |
| Serbia | 61,7 | 61,0 | 61,7 | 61,4 | 59,8 | 60,7 | 60,8 |
| European Union | 71,9 | 72,4 | 74,1 | 73,7 | 73,6 | 73,9 | 74,1 |

**Source:** World Bank

As regards the historical conditions of the Western Balkans still remains utopian goals the

political criteria related to fiscal transfers between countries, joint solutions for the economic crisis and cross-border financial solidarity.

## 4. Conclusions

The European Union itself it is not completely an Optimal Currency Area.

Although the western Balkan countries has similar economic conditions, these countries are far from an adequate condition in order to create a common monetary area.

Taking into account the differences in economic indicators mentioned above, the participation of the Balkan Countries, here analyzed, in the euro area does not seem to be advisable and would expose them to the effects of asymmetric shocks, at least according to the theories of "Optimal Currency Area" developed by Mundell, McKinnon and Kenneth.

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