Abstract

This paper estimates the determinants of exchange rate variability for 21 developed economies in 1980-1998. The results show that traditional criteria implied by the optimum currency area (OCA) theory, such as business cycle synchronisation, trade linkages and economy size, determine to a large extent bilateral exchange rate variability. Using the ordinary least squares estimation, we compute OCA indices for European economies vis-à-vis Germany and identify countries showing consistently large or little signs of convergence. We find that since 1998, most European developed economies have converged to Germany whether or not they are using the euro, suggesting that structural similarity is not driven solely by monetary integration. Our results from the model estimated by the generalized method of moments suggest that two additional criteria reflecting labour market flexibility and private credit growth are significant in explaining the exchange rate variability and lead to a ranking of countries different from the traditional approach. We find a positive relationship between the OCA indices and GDP decline during the economic crisis of 2008-09, which further supports the view that the OCA index is a useful indicator of the candidates' readiness to join the Euro Area. We apply the results to the countries of Central and Eastern Europe and conclude that countries which have already adopted the euro are not those that would benefit the most from it, as predicted by the OCA theory.

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