Towards an Individualistic Theory of Optimum Currency Areas

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Abstract

In this paper we argue that the traditional theory of optimal currency areas, derived from Mundell (1961) cannot be made operational. In particular, we try to show that it is based on obsolete tenets of neo-Keynesian macroeconomics and that it lacks a defensible criterion of optimality, as it is founded not on individuals' preferences concerning money but on a set of more or less arbitrary macroeconomic requirements. We then claim that the question of size and composition of a currency area is not only a question which cannot be answered by the theory of optimum currency areas but that it is a question which can be answered only by a process of competition. Thus, we propose an alternative approach to optimality of monetary areas which is rooted in a broad theory of money as medium of exchange. The theory we put forward in this paper is not novel, and is much inspired by Hayek (1978) and Salin (1993). Its central element is the emphasis on the institutional arrangement of money issue, as we think that the problem of production of money is a problem of possessing the institutions ensuring that the outcome will be optimal from the perspective of consumers. We believe that such arrangement can be found by introducing competition into money issue.