An Optimal Pathway to Economic Convergence in the EMU

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In the aftermath of the global financial crisis, intrinsic political and economic challenges have raised questions about the survival of the European Monetary Union (EMU). To the extent that we can view the crisis as an asymmetric employment shock, we are reminded that national level barriers to labour mobility do not make for strong optimal currency area arguments. In addition, price level inflexibility and homogenous borrowing costs across the EMU[1] have resulted in continued high unemployment and disparities in real exchange rates that cannot be met by nominal revaluations[2]. The severe sovereign debt crisis and resulting reversals in capital currents[3] are raising fears of social and economic divergence. With a variety of proposed solutions to choose from, this paper argues an enhanced community level fiscal transfer system, funded from an increased transnational tax base, is an optimal pathway toward business cycle convergence in the EMU.

The development of literature on optimal currency area criteria, beginning with Mundell in 1961, has solidified monetary union theory. The foundations of any successful currency union are said to include:[4] extent of trade, similarity of shocks and cycles, system of risk sharing, usually fiscal, and labour mobility. Underlying these criteria is a trilemma, or "impossible trinity principle" that allows only two of the three characteristics: an independent monetary policy, a fixed exchange system and full capital mobility.[5] The usual settlement account balance equation stipulates that imbalanced exchanges of goods must be met with imbalanced exchanges of currency, implying that equilibrium in currency markets can only be maintained by open market operations or currency revaluations. Thus when regions or nations exposed to exogenous shocks respond with productivity differentials and independent currencies cannot be revalued, real exchange rates deviate and business cycles exhibit asynchronous behaviours. The nature of the international credit crisis and the business cycle variations between, say Ireland and Germany, provide an example of currency union criteria impeachment. The massive outflows of capital from Ireland in the wake of property devaluations have brought the Irish business cycle to a crashing halt. Though German businesses were also exposed to external demand shocks, the Irish use of IMF emergency lending suggest capital did not flee Germany at the same rates it did Ireland. In the absence of an independent

1 Baldwin, referenced text, page 408.
2 Exchange rate revaluations being nominal, real exchange rate revaluations implying productivity wage ratios.
3 Directions of capital flows.
4 Frankel and Rose, in 1997. Hitiris, page 128 expands trade to include services and capital.
5 Baldwin, referenced text, page 335.

monetary policy or exchange rate buffer, to provide more immediate downward price flexibility and stimulate export demand, what adjustment process can stimulate growth in Ireland? The usual answers are labour mobility, price flexibility, or fiscal stimulus.

In an exogenous employment shock, when we talk of price flexibility, we are often talking about labour flexibility. With this in mind, we may recall the significant body of literature suggesting trends in European social policies lend Keynesian sticky price characteristics to European labour markets.[6] For example, if there are strict employment protection regulations, employers may be more careful about whom and how many workers they hire (Pissarides, 2008). Horst Siebert, 1997, regresses labour market data across a variety of institutional conditions. His analysis gives more detailed evidence that trends in European labour market institutions impede labour market flexibility. Intuitively, if this is or is not the case does not seem highly relevant; even flexible labour markets are known to be structurally sticky in the short-run.

Not to confuse labour market flexibility with labour market mobility, and in keeping with our examination of potential adjustment mechanisms, we note that labour mobility in Europe is also highly restricted. This is well documented,[7] and not surprising, considering existing varieties of linguistic and cultural distinction across the EMU. To Pissarides, European labour markets are more like closed national markets than integrated European regions.

Fiscal stimulus is the far more controversial adjustment mechanism. The issue at hand is if national stimulus programs must be implemented cooperatively or independently. Von Hagen and Wyplosz, 2007, are not convinced that the theory of Fiscal dominance[8] is concrete support for the Growth and Stability Pact (GSP). They are sceptical of the simplicity of IS-LM theory[9] as it applies to spiralling interest rates in the EMU. That said, they provide significant support that fiscal indiscipline can become a source of inflation. Engwerda et al., 2002, approach the ineffectiveness of non-cooperative domestic fiscal policies from a game theory perspective[10]. They emphasize that domestic fiscal policies impact foreign outputs through import channels and price fluctuations.[11] Their model indicates strictly contained and cooperative fiscal policies reduce welfare loss and decrease the adjustment process time span. At the root of this

6 Incidentally, Ireland may be the exception to this trend, having perhaps the most flexible labour markets in Europe.

7 Engwerda shares this view and assures us that Decressin and Fatas (1995) do also.

8 Whereby one countries' deficits impose an interest rate cost-externality on all other countries in the union

9 We can easily relate by considering the Keynesian liquidity trap. Also, it is clear that in today's global economy, to remain competitive, many central banks must adopt exogenous interest rates.

10 A linear quadratic differential game between national fiscal authorities analyzing the Nash open-loop and cooperative equilibria.

11 Fiscal stimulus may drive up domestic prices via demand side, output fluctuations may force foreign to reduce prices, regardless of business cycle stage.

argument is mathematical evidence that, within the assumptions of their model, non-cooperative fiscal policies beget disequilibrium in interdependent economies, leading to a slower adjustment process. They suggest incentives for fiscal cooperativeness and stringency include the internalization of inter-dependencies and negative spillovers. Iara and Wolff, 2010, provide additional evidence that stringent fiscal rules are beneficial. They argue fiscal stringency reduces sovereign risk spreads and improves certainty in financial markets. Again, in either case, fiscal cooperativeness is mandated by Maastricht criteria and independent fiscal policies are not, theoretically, available as adjustment mechanisms in an asynchronous businesses cycle fluctuation environment.

Von Hagen and Wyplosz, 2007[12] inform us that, in lieu of varying economic developments, all federal like polities provide mechanisms to redistribute income. Indeed, one argument is that current community level policies are adequate. The disastrous record of SGP criteria infringements, as depicted by Baldwin[13] and supported by the November 2003 Council decision to put the SGP "in abeyance"[14] strongly suggests this is not the case. We also see, in 2009 every member of the EMU had a budget deficit in excess of 3%.[15] Though this increase in public debt is in keeping with post crisis global trends, variations in both budget deficit ratios and accumulations in public debt, may suggest current transfer programs and funding cohesion policies are not adequately serving their purpose.

Further to the point, the size of EU level expenditures relative to international actors is minimal. A comparison of EU and UK budget outlays shows the EU, in 2010 spent 141.5 billion Euro[16]. UK 2010 outlays were 697 Pounds or 825.58 billion Euro, roughly 6 times larger. Yet the combined EU GDP for 2009 was 7.5 times that of the UK. Any comparative analysis of the EU budget, relative to its economic magnitude, demonstrates the combined community level cohesion policy and structural fund expenditures are smaller than similar expenditures in any nation of the G20. We can infer, as far as fiscal transfers or collective insurance policies are concerned, the EU as a transnational actor is relatively passive.

If we turn to EU transfer funding mechanisms outside the comparatively minute structural fund programs, like the EU Investment Bank, the EU Investment Fund and the European Financial Stability Facility, we see primarily market funding programs. The difference between a tax base distribution vehicle and a market funded distribution vehicle, namely that small countries may face upward-sloping credit

12 Here they reference Ingram, 1959.
13 Page 416 of referenced text.
14 Von Hagen and Wyplosz (2007).
15 Euro Stat measured the average EMU deficits as percentage of GDP for 2009 to grow from 2.0% to 6.3%
16 Comparisons use Euro Stat and U.K. Treasury numbers, converted with Bank of Canada 10 year currency converter, Feb 05, 2011.

supply curves in turbulent market scenarios, forms one of the key arguments for the Von Hagen and Wyplosz 2007 defence of common fiscal insurance. They determine, through rigorous mathematical analysis, that "pooling the individual consumption-smoothing policies will yield a reduction in the aggregate cost of borrowing."[17] Though Von Hagen and Wyplosz may have paid more attention to fiscal transfer targets, ie: intergovernmental transfers versus transfers to homes (employment insurance),[18] the credit market nature of the 2008 shock strengthens the sloping credit market argument.

If the Euro Zone has an Achilles heel, it is a political one and not an economic one. As such, most of the arguments against an enhanced fiscal transfer system are political arguments. Baldwin reminds us of preference heterogeneity and information asymmetries, both good reasons supporting the heavy national level weight we see in aggregated EU budget expenditures[19]. He also reminds us that article 5 of the Maastricht Treaty apportions responsibilities to the community level only when they cannot be sufficiently performed at the national level. The trade off then is one of economic viability versus political viability. And though, in these cases, political viability is the invariable favourite, there is also a strong political argument for an enhanced transfer of fiscal authority to the community level. Von Hagen and Wyplosz cite a long tradition of poorly timed national level policy implementations, implying governments often do seek political gain over macroeconomic stability. To Baldwin, "The question here is whether Brussels performs better than the national governments." Taking his "quality of government" question in the context of Engwerda's work on non-cooperative fiscal policies, and how their outcomes may perpetuate disequilibrium, the topic garners a leveraged importance. Even if only a few national governments are only sometimes more susceptible to interest group pressures, the resulting externalities can have pan-national effects. Applying the principles of competitive markets to the lobby market, we have an argument that, at the community level, any single national level interest group will have watered down access to policies with far reaching effects.

To return to the concept of economic divergence or convergence in distinct economies joined by a common currency, it is the nature of freely flowing capital, in capitalist societies, to move to regions where it may yield an optimal return. Given that capital can increase the marginal product of labour, in cases where technology growth renders positive effects that outweigh depreciation and population growth,[20] productive regions, with more efficient institutions and factor returns, can experience higher

17 Here they reference Hammond and Von Hagen, 1998.
18 The results varied with the nature of the shock and a mixed bag, so to speak, was recommended.
19 Page 411 of referenced text. Roughly akin to cultural preservation and localized decision making, respectively.
20 The steady state is not yet achieved.

economic growth rates. When currency is fixed across trading partners, these growth rates can increase exports.[21] The same logic implies that regions with lower productivity, can be priced out of intra-industry markets and suffer stagnant or decreasing factor returns. The absence of mobile labour markets, flexible price levels, exchange rate adjustment mechanisms and independent monetary policies create conditions for a "two speed" currency union. For these reasons countries in monetary unions adapt policies that redistribute surplus capital from productive areas to those that are less productive.

Apart from suggesting labour markets in the EMU are inflexible, prices sluggish and independent monetary policies and exchange rate mechanisms unavailable, this paper reviewed the theoretical limitations of non-cooperative national fiscal policies. The empirical and theoretical work of Engwerda et al., and Von Hagen and Wyplosz suggest these policies are suboptimal tools for fostering economic convergence. Alternative options, seriously debated, include an enhanced community level fiscal transfer system[22] and the current system of relatively minute tax based transfers mixed with sovereign guaranteed credit market instruments. It was suggested that credit market instruments are costlier than tax based transfers and that the current system of structural funding was inadequate. At the crux of the EMU dilemma is the trade off between the political losses realized by transferring sovereign fiscal authority to the community level and the economic gains of the same. History reminds us, without adequate economic converging policies, successfully maintaining a monetary union is a short lived venture. It light of these arguments, and in response to the question of how to ensure the survival of EMU, it is readily apparent an enhanced fiscal transfer system, funded from a community level tax base, is an optimal pathway toward business cycle convergence in the EMU.

21 If currencies readjusted, ceteris paribus, higher capital accumulation would lead to appreciation and lower exports.
22 Community employment insurance can be included in the former.

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