A joint Initiative of Ludwig-Maximilians-Universität and Ifo Institute for Economic Research

# CESifo Workshop on EURO-AREA ENLARGEMENT

24 November 2006

CESifo Conference Centre, Munich

## On Monetary and Political Union

Paul De Grauwe

CESifo
Poschingerstr. 5, 81679 Munich, Germany
Phone: +49 (0) 89 9224-1410 - Fax: +49 (0) 89 9224-1409
office@CESifo.de
www.cesifo.de

# ON MONETARY AND POLITICAL UNION

**Paul De Grauwe**

**University of Leuven**

October 2006

Paper prepared for the CESifo Workshop on "Enlarging the Euro Area" to be held on Friday 24 November 2006, Munich. Previous versions of this paper were presented during seminars at Sciences Po, Paris, at the London School of Economics, at the Universities of Genoa, Macerata, and Siena and at the European University Institute, Florence. I am grateful to Elisabetta Croci Angelini , Francesco Farina, Marc Flandreau, Franco Praussello, Francesco Saraceno, Waltraud Schelkle, An Sibert, Patrizio Tirelli and Frédéric Zumer for comments and criticism.

## 1. Introduction

Recent political developments in Europe, in particular the rejection of the European Constitution in France and the Netherlands in 2005, are leading to soul searching about the future of the European Union. There can be little doubt that these developments signal distrust towards a further political integration in Europe.

The risk that the process towards political union will be halted or even reversed has triggered a new debate about the link between political and monetary union. Two schools of thought have emerged. According to one school monetary union cannot survive in the long run without a strong political union among the member states. This school of thought seems to have history on its side. Monetary unions that were not embedded in a strong political union have not survived.

According to the second school of thought the present degree of political unification reached in the EU is sufficient to guarantee the long run survival of the monetary union. In this view, the Eurozone can survive even if the EU does not become a Federal state like the United States of America.

The debate between these two views about the link between political and monetary union is made difficult by a lack of clarity about the meaning of political union. While a monetary union can easily be defined, i.e. it is a union between countries that use the same currency which is managed by one common central bank, such a neat definition is not easily found for the concept of political union. There are many dimensions and many gradations of political union. In contrast to monetary union, a political union is not a black or white affair that allows us to say when exactly the political union has been reached.

In this paper we analyze the link between political and monetary union. We start by clarifying the concept of political union, and we then go on analyzing what kind of political union is necessary to sustain the monetary union in the long run.

## 2. The many dimensions of a political union

A political union has many dimensions[1]. Let us distinguish between an institutional and a functional dimension.

At the institutional level one can analyze the nature of the institutions that govern the union. There can be little doubt that the European Union has now developed a whole set of institutions to which the member states have delegated part of their national sovereignty. There is an executive branch consisting of the Commission and the Council. There is a legislative branch consisting of the Council and the European Parliament, and there is a judicial branch, the Court of Justice. Apart from the peculiar role of the Council as an institution with both a legislative and executive responsibility, the European Union has all the institutions of a modern democracy, capable of taking decisions that have a direct impact at the national level. In this sense there is already a significant degree of political union within the EU. The question we will have to analyze is whether the existing level of political union is sufficient to sustain the monetary union.

At the functional level one can ask the question about the areas in which the member states have transferred their sovereignty to the European institutions. Here we have a very diverse picture. In some areas, the transfer has been significant. In agriculture, competition policy, external trade policy there is a substantial transfer of sovereignty.

In other areas there has been very little transfer. The most prominent (economic and social) areas where the member states have maintained the whole or close to the whole of their sovereignty is taxation, social security, wage policies, to name the most obvious ones. There are other areas where the transfer of sovereignty has been very limited, e.g. defense and foreign policies[2].

Thus it appears that the transfer of sovereignty has proceeded in a very unequal way in the European Union, some areas being characterized by almost complete transfer of sovereignty and others by only very limited transfers.

The question that arises is what areas are important for a monetary union. Do we need a transfer of sovereignty in all these areas so that the European institutions become the

[1] It is not the intention here to develop a full-fledged theory of political unions. We only want to highlight those features that are important for the debate about the link between political and monetary union. For a profound analysis, see the well-known textbook of Wallace and Wallace(2000).
[2] For a more detailed analysis see Alesina, et al. (2001) and Alesina and Spolaore(2003).

embodiment of a true "superstate", or can this transfer be selective? If the latter is true, what principles should be followed to allocate responsibilities between the union and the member-states? In order to answer these questions we turn to the theory of optimal currency areas.

## 3. The theory of optimal currency areas and political union

There is a fundamental difference between the monetary union between the US states and the European monetary union. The US Federal government has a monopoly of the use of coercive power within the union, and will surely prevent any state from seceding from the monetary union. The contrast with the member states of the Eurozone is a very strong one. There is no supranational institution in the EU that can prevent a member state of the Eurozone from seceding. Thus, for the Eurozone to survive the member states must continue to perceive their membership of the zone to be in their national interest. If that is no longer the case, the temptation to secede will exist and at some point this temptation will lead to secession.

The theory of optimal currency areas determines the conditions that countries should satisfy to make a monetary union attractive, i.e. to ensure that the benefits of the monetary union exceed its costs. This theory has been used most often to analyse whether countries should join a monetary union. It can also be used to study the conditions in which existing members of a monetary union will want to leave the union.

In its most general formulation the OCA-theory says that if the benefits of the monetary union exceed the costs, member countries have no incentive to leave the union. They form an optimal currency area. Or put differently, they are in a Nash equilibrium, and the monetary union is sustainable.

The conditions that are needed to guarantee sustainability are well-known from the literature on optimal currency areas (OCA)[3]. They can be summarized by three concepts

- Symmetry (of shocks)
- Flexibility

[3] McKinnon(1963), Kenen(1969).

- Integration

Countries in a monetary union should experience macroeconomic shocks that are sufficiently symmetric with those experienced in the rest of the union (*symmetry*). These countries should have sufficient *flexibility* in the labour markets to be able to adjust to asymmetric shocks once they are in the union. Finally they should have a sufficient degree of trade integration with the members of the union so as to generate benefits of using the same currency.

One can summarize this theory in the form of graphical representations. This is done in figures 1 and 2.

Figure 1 presents the minimal combinations of *symmetry* and *flexibility* that are needed to form an optimal currency area by the downward sloping OCA-line. Points on the OCA-line define combinations of symmetry and flexibility for which the costs and the benefits of a monetary union just balance. It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility. To the right of the OCA-line the degree of flexibility is sufficiently large given the degree of symmetry to ensure that the benefits of the union exceed the costs. To the left of the OCA-line there is insufficient flexibility for any given level of symmetry.

Figure 2 presents the minimal combinations of *symmetry* and *integration* that are needed to form an optimal currency area. The OCA-line represents the combinations of symmetry and integration among groups of countries for which the cost and benefits of a monetary union just balance. It is downward sloping for the following reason. A decline in symmetry raises the costs of a monetary union. These costs are mainly macroeconomic in nature. Integration is a source of benefits of a monetary union, i.e. the greater the degree of integration the more the member countries benefit from the efficiency gains of a monetary union. Thus, the additional (macroeconomic) costs produced by less symmetry can be compensated by the additional (microeconomic) benefits produced by more integration. Points to the right of the OCA-line represent groupings of countries for which the benefits of a monetary union exceed its costs.

**Figure 1: Symmetry and flexibility as OCA-criteria**

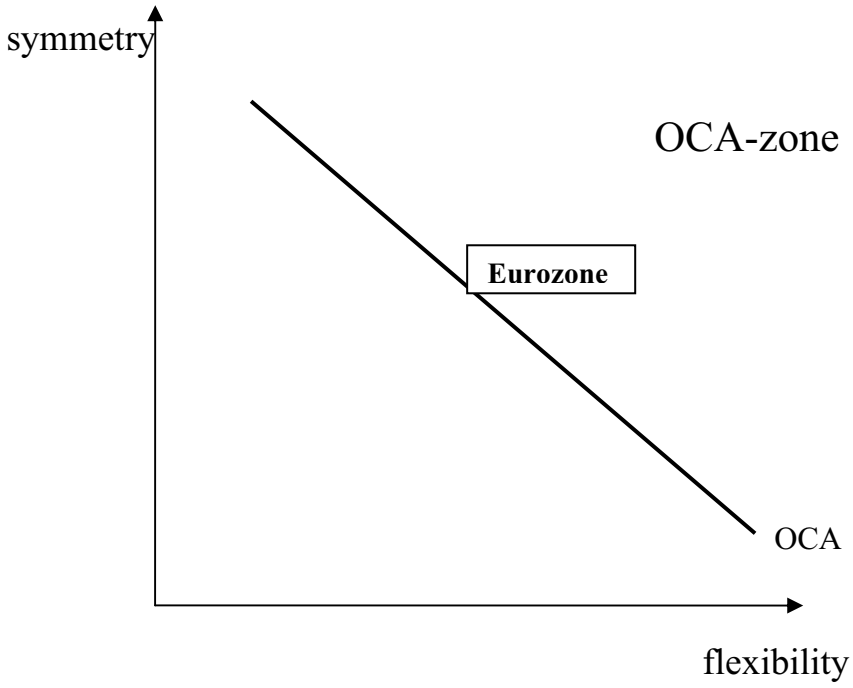
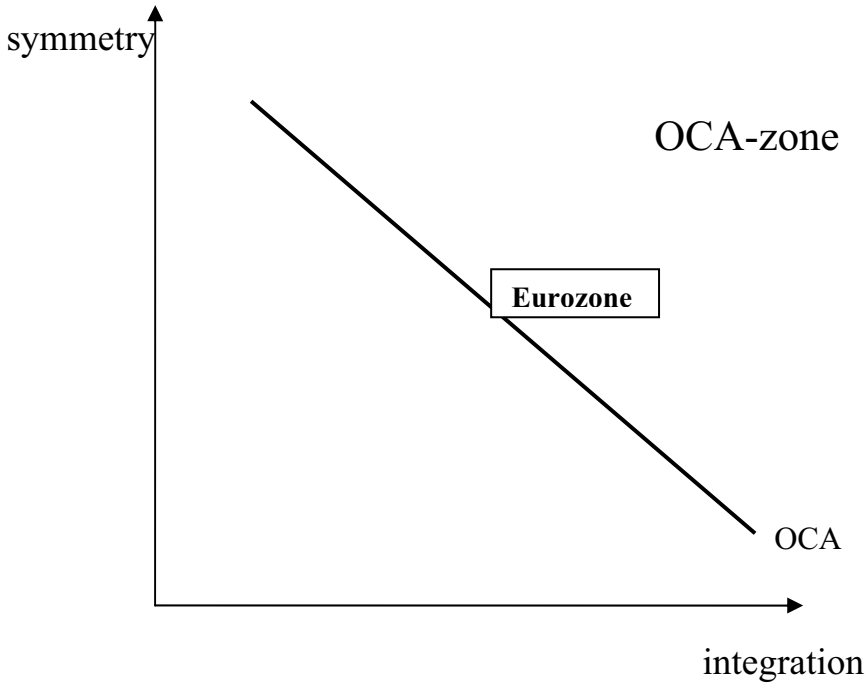



**Figure 2: Symmetry and integration as OCA-criteria**




We have put the present Eurozone (EU-12) within the OCA-zone, but close to the border line, taking the view that the Eurozone may be an optimal currency area, however, without being really sure of this. The Eurozone may also be on the left had side of the OCA-line. This implies that we are not really sure whether it is sustainable

in the long run. As a result, there may be scope for improving the sustainability of the eurozone.

**How does political integration affects the optimality of a monetary union?**

We take the view that the degree of political integration affects the optimality of a monetary union in several ways. First, political union makes it possible to centralize a significant part of national budgets at the level of the union. This makes it possible to organize systems of automatic fiscal transfers that provide some insurance against asymmetric shocks. Thus when one member-country is hit by a negative economic shock, the centralized union budget will automatically transfer income from the member states that experience good economic conditions to the member state experiencing a negative shock. As a result, this member state will perceive the adherence to the union to be less costly than in the absence of the fiscal transfer.

Second, a political union reduces the risk of asymmetric shocks that have a political origin. To give some examples that are relevant for the Eurozone. Today spending and taxation in the Eurozone remain in the hands of national governments and parliaments. As a result, unilateral decisions to lower (or to increase) taxes create an asymmetric shock. Similarly, social security and wage policies are decided at the national level. Again this creates the scope for asymmetric shocks in the Eurozone, like in the case of France when that country decided alone to lower the working week to 35 hours. Or take the case of Germany which by applying tough wage moderation since 1999, dramatically improved its competitive position within the Eurozone at the expense of other countries, e.g. Italy (see next section where we elaborate on this). From the preceding it follows that political unification reduces the scope for such asymmetric shocks.

The way one can represent the effect of political unification is twofold (see figure 3). First, the existence of a centralized budget makes it possible to alleviate the plight of countries hit be a negative shock. Thus the cost of the union declines for any given level of asymmetry. This has the effect of shifting the OCA-lines downward in figures 1 and 2[4]. Second, political union reduces the degree of asymmetry, thereby shifting

[4] It is important that these transfers be reversible to maintain their insurance character. If these transfers attain a permanent one way character they are likely to become unpopular in the

the Eurozone upwards. As a result of these two shifts, political unification increases the long-term sustainability of monetary unions[5].

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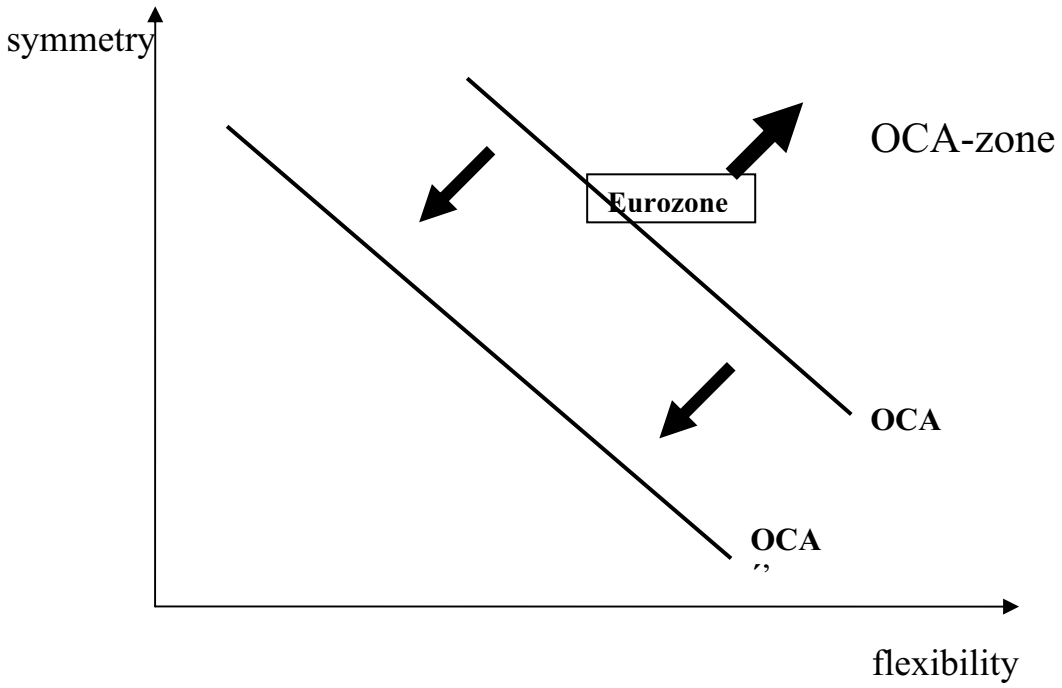
**Figure 3: Political integration and the optimality of the Eurozone**




From this brief survey of the OCA-theory we conclude that in order to enhance the sustainability of a monetary union it is important to have a central budget that can be used as a redistributive device between the member states and it also matters to have some form of coordination of those areas of national economic policies that can generate macroeconomic shocks. The reason why this coordination is important is that these macroeconomic shocks spillover into the monetary union. For example, the decline in the working time in France was equivalent to a negative supply shock in France. This affected aggregate output in the Eurozone and thus the conduct of monetary policies by the ECB. This in turn influences all the other member states of the Eurozone.

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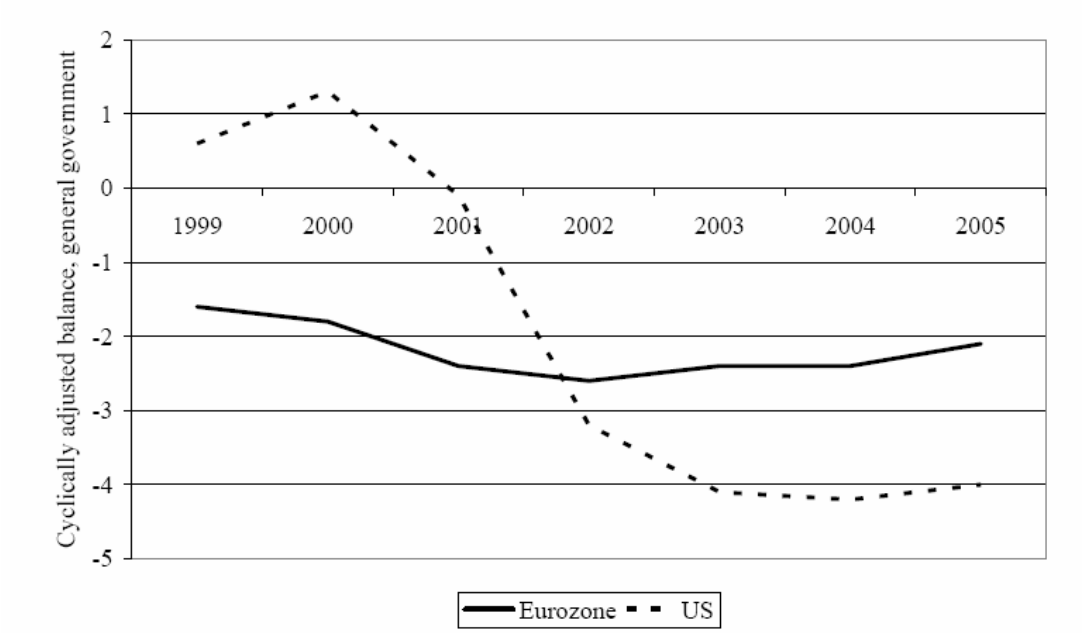
"donator"-country, leading to a perception of a high cost of the monetary union. This calls for the use of transfers only to alleviate the effects of temporary asymmetric shocks (business cycle movements) or in the case of permanent asymmetric shocks to make these transfers temporary allowing receiving countries to spread the adjustment cost over a longer time.

[5] A similar analysis can be done using the symmetry-integration space of figure 2.

A central budget is important as a redistributive device. It also matters as a stabilizing instrument[6]. The absence of a central budget in the Eurozone implies that no budgetary policy aimed at stabilizing the business cycle in the union is available. The question that arises here is how important this is. In figure 4 we show the contrast between the US and the Eurozone since 1999. We observe that the US allowed its budget deficit to increase significantly as a response to the recession of 2001. There is no central budget in the Eurozone but the aggregate of the national budget balances could work in a similar stabilizing way. The evidence of figure 4, however, shows that this aggregate did not respond to the worsening economic conditions in the Eurozone from 2002 on. Thus there is an absence of a system-wide budgetary policy in the Eurozone capable of performing a stabilizing role at the level of the Eurozone.

**Figure 4: Cyclically adjusted budget balance in the Eurozone and the US**




*Source*: European Commission.

## 4. Asymmetric shocks and lack of political union

One of the surprises of the functioning of the Eurozone has been the extent to which the competitive positions of the Eurozone countries have diverged. We show the real

[6] Musgrave(1959) introduced the different functions of a government budget, as a distributive, a stabilizing and a

effective exchange rates in the Eurozone (based on unit labour costs) since 1998 in figure 5. The striking fact is the extent to which the relative unit labour costs have tended to diverge. As a result of these trends, some countries (Portugal, Netherlands, Spain and Italy) have lost a significant amount of price and wage competitiveness. Others, like Germany and Austria have gained a significant amount of price and wage competitiveness[7].

There can be no doubt that part of these divergent developments in prices and wages are the result of divergent national wage policies. Since 1999, Germany has followed a tight policy of wage moderation. We show some evidence in figure 6. This presents the yearly nominal wage increases in Germany and in the rest of the Eurozone (excluding Germany). We observe the strong decline of nominal wage increases in Germany. The rest of the Eurozone maintained more or less constant wage increases around 3% per year. Thus, each year Germany tended to improve its competitive position vis a vis the rest of the Eurozone. The contrast between Germany on the one hand, and the UK and the US on the other, is even stronger. The latter allowed their wages to increase by 4 or 5% per year.

This German policy of wage moderation has not been without consequences for the other Eurozone countries which have seen their competitive positions deteriorate thanks to these German wage policies. Thus the latter have worked as "beggar-thy-neighbor" policies forcing other countries in turn to also institute drastic policies of wage moderation[8]. In this sense the lack of political union is responsible for a coordination failure and the emergence of a major asymmetric shock that will have to be corrected.

The correction mechanism is likely to be painful. Other countries will be forced to intensify their policies of wage moderation, inducing the former again to restrict wage increases. All this is adding to deflationary tendencies characterized by low growth in consumption and investment and by increasing unemployment.

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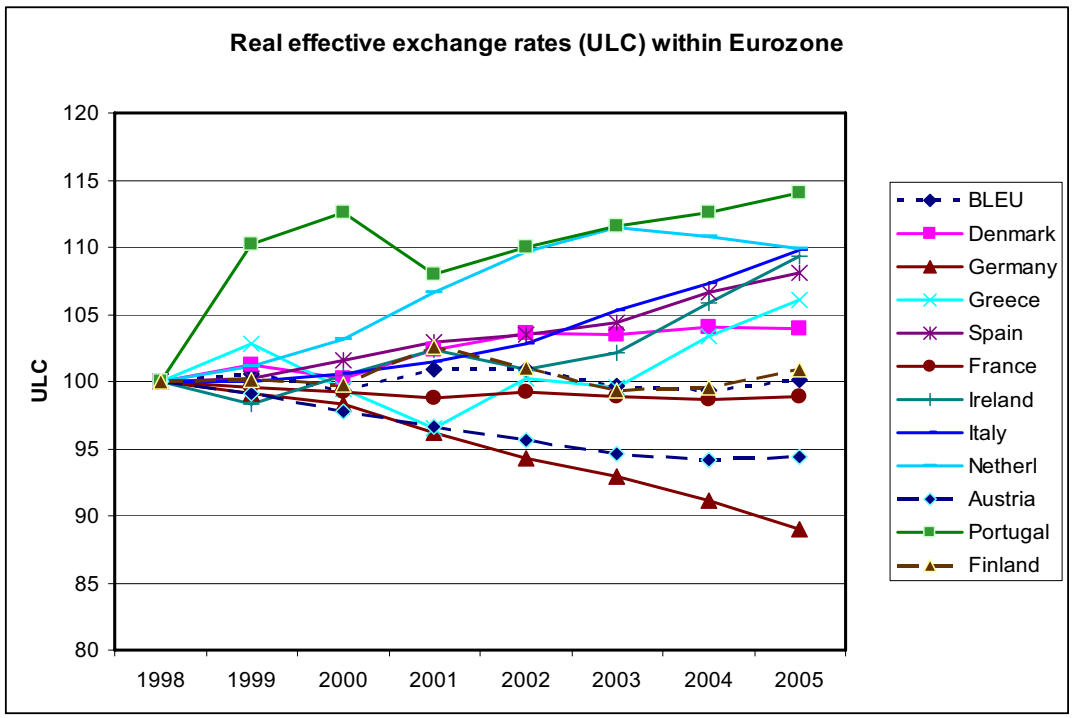
[7] It could be argued that these trends may also be the result of different initial levels of per capita income so that they reflect a catch-up process (Balassa-Samuleson effect). Since the real effective exchange rates shown here are based on unit labour costs they take into account differences in productivity growth.

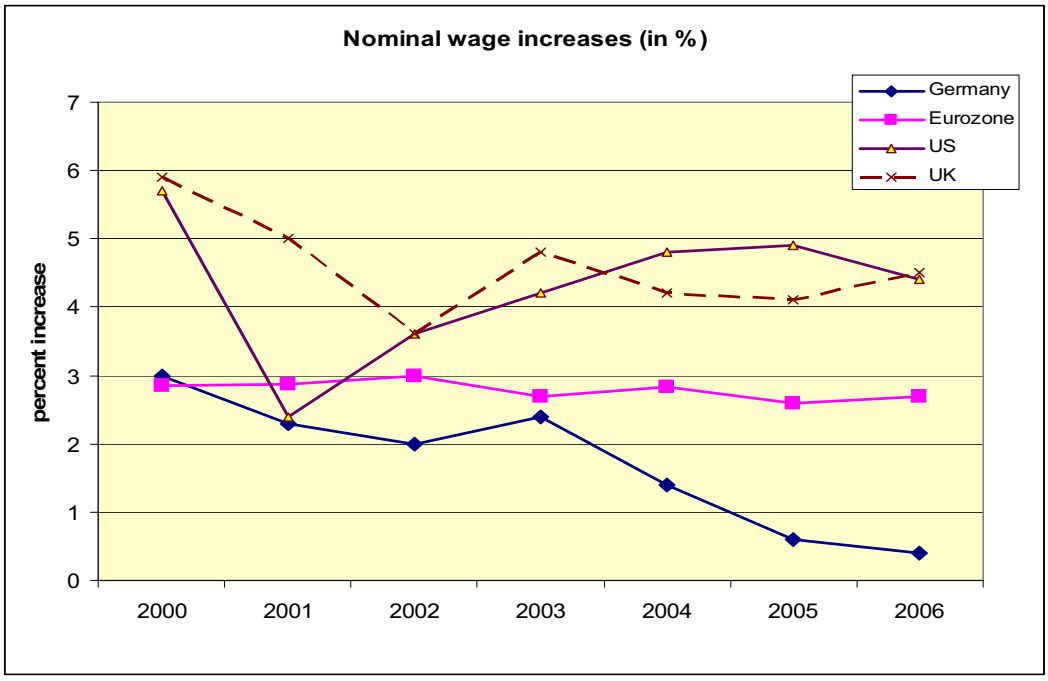
[8] For a similar analysis in the context of the EMS, see Blanchard and Fitoussi(1992).

**Figure 5 : Intra-euro area real effective exchange rates (based on ULC)**




*Source*: European Commission

**Figure 6**




Source: European Commission, Statistical Annex to the European Economy

The divergent movements of competitive positions within the Eurozone are not only the result of German wage policies but also of the different speeds in the structural reform process in the member countries. The process of structural reforms (labour market reforms, liberalization of output markets) has remained a strictly national affair. Some countries, e.g. the Netherlands and Spain have gone some way in deregulating employment protection systems, while other countries, e.g. France and Italy have a long way to go. These divergent movements have much to do with differences in national political systems. They generate a potential for divergent movements in employment and output (asymmetric shocks) within the Eurzone which will necessitate adjustments in the future. As these are likely to be painful, they are bound to lead to tensions in a monetary union.

## 5. The Brussels-Frankfurt consensus

The previous analysis and its conclusion that a further political union is necessary for the long-run sustainability of the Eurozone is very much disputed by the Brussels-Frankfurt consensus, which has also become the official view. This view can be summarized as follows.

First, the way to deal with asymmetric shocks is to increase flexibility. As we showed in figure 1, an increase in flexibility raises the sustainability of a monetary union. Thus a monetary union can be made sustainable by introducing structural reforms.

Second, the Stability and Growth Pact (SGP) provides all the needs for countries to use national fiscal policies as an instrument to deal with asymmetric shocks that have a cyclical (temporary) component. By following the SGP-prescription of a balanced budget over the medium run, countries have enough flexibility to allow their budget deficit to increase up to 3% during an economic downturn. As a result, the Eurozone countries have the instrument to deal with business cycle movements.

Third, there is no need to have a system-wide budgetary policy to stabilize the business cycle. Monetary policy of the ECB is perfectly equipped to provide for macroeconomic stability in the Eurozone. By focusing on price stability the central bank does all that can be done to stabilize output movements at the Eurozone level. The reason is the following. If the output shocks are due to demand movements, inflation targeting will not only stabilize the rate of inflation but also the output

movements. If these output movements are due to supply shocks they cannot be dealt with by monetary policies and/or budgetary policies.

The conclusion from this analysis is that the present European institutions are appropriate to sustain the monetary union in the long run. There is no need to increase the degree of political unification to make the monetary union sustainable. The Eurozone can survive in the long run without the need to create a European super state.

## 6. Comparing the two views

What to think of these two strongly opposing views. At the outset it can be interesting to focus on the underlying economic paradigms of these two views.

The Brussels-Frankfurt consensus is based on two academic theories. One is the monetarist theory in which the central bank cannot do much to stabilize the economy. If it tries too hard to "fine-tune" the economy it will end up with more inflation. Thus the best thing a central bank can do is to stabilize the price level. This will have the incidental effect of producing the best possible outcome in terms of stability of the economic cycle. The second theory that influences the Brussels-Frankfurt consensus is the real business cycle theory. This says that the sources of economic cycles are shocks in technology (supply side shocks) and changes in preferences (unemployment being mainly the result of workers taking more leisure). There is very little the central bank can do about these movements. The best is to keep the price level on a steady course. This will minimize the effects of these shocks. In addition, a macroeconomic policy based on the objective of price stability is the best thing the central bank can do to promote growth. As Lucas has stressed, the central bank's contribution to economic growth by maintaining price stability is immensely more important than an ephemeral success in reducing business cycle movements.

It will come as no surprise that if one adheres to these theories the present institutional setup in the Eurozone is the best of all possible worlds: a central bank that cares about price stability and in so doing makes the best possible contribution to maintaining macroeconomic stability and to fostering economic growth; and national governments that keep budgetary discipline and do their utmost to introduce market flexibility. In such a world the productivity driven shocks can best be dealt with by governments

keeping budgets in balance. Furthermore, in such a world the need to have an active budgetary policy at the Eurozone level does not exist[9].

The theoretical underpinnings of the alternative OCA-view are very different and are deeply rooted in Keynesian and neo-Keynesian ideas. In this view there are shocks in the economy that do not originate in the supply side but find their origin in the demand side. "Animal spirits", i.e. waves of optimism and pessimism capture consumers and investors. These waves have a strong element of self-fulfilling prophesy. When pessimism prevails, consumers and investors alike hold back their spending, thereby reducing output and income, and validating their pessimism. Similarly, when optimism prevails, consumers and investors will spend a lot, thereby increasing output and income, and validating their optimism.

The corollary of this effect is the well-known savings paradox. When pessimism prevails and consumers attempt to save more, the ensuing decline in income will prevent them from increasing their savings ex post. These phenomena have been analyzed by Keynes long ago, but have been thrown in the dustbins of economic history. Yet these ideas remain powerful, and have important influences on the optimal design of the monetary union.

In the logic of these Keynesian ideas, a monetary union needs a central budgetary authority capable of offsetting the desire of consumers gripped by pessimism to increase their savings, by dissaving of the central government. In addition, to the extent that there are asymmetric developments in demand at the national level, the existence of an automatic redistributive mechanism through a centralized budget can be a powerful stabilizing force. Finally, in this view the responsibility of a central bank extends beyond price stability (even if this remains its primary objective). There are movements in demand that cannot be stabilized by only caring about price stability.

From the preceding analysis it appears that the present governance of the Eurozone has been devised based on the assumption that the world is one which fits the

[9] It will also not come as a surprise to those who have studied economic history that these were also the views that prevailed prior to the Great Depression.

monetarist-real-business-cycle (MRBC) theory[10]. If the latter theory is indeed the correct view of the world, there is little need to move on with political integration in the Eurozone, and the present political governance of the Eurozone is perfectly adapted to the world in which we live.

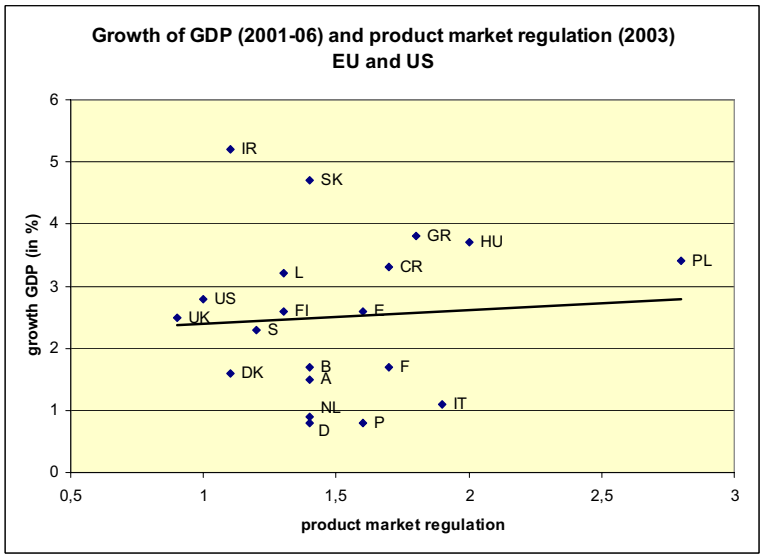
## 7. A preliminary evaluation

It is not easy to evaluate these radically different views. Here I provide some tentative and partial empirical evidence. The central tenet of the MRBC-theory and the Brussels-Frankfurt consensus is that the low growth performance of the eurozone since the early 2000s is due to the existence of rigidities in the product and labour markets. Thus, I ask the question of whether the extent of regulation in the goods and labour markets is a good predictor of growth performance of countries since the start of the decade?

Let us start with good market regulation. The OECD computes an index of product market regulation in the OECD countries. It is described in greater detail in appendix. We relate this index with the growth performance of the EU-countries and the US since 2001 when the Eurozone was gripped in a prolonged slowdown of its economic growth. Is this index a good predictor of the growth performance of these countries? More precisely, is it the case that countries that had more product market rigidities suffered more from the slowdown than countries with less rigidity. We use both the growth of GDP (figure 7) and productivity growth (figure 8) to evaluate this question. We also add the result of a simple regression analysis relating growth during 2001-2006 and the index of product market regulation. It appears from this simple exercise that product market regulation is a very poor predictor of the growth performance of the sample of countries during this period. Product market regulation even appears to be associated with higher growth, although the coefficient is not statistically different from 0.

[10] I am lumping together monetarist and business cycle theories. This does not mean that they may not be very different in some respects. For example, monetarists recognize that monetary policies can be important sources of business cycle developments, while real business cycle theorists tend to dismiss this view.

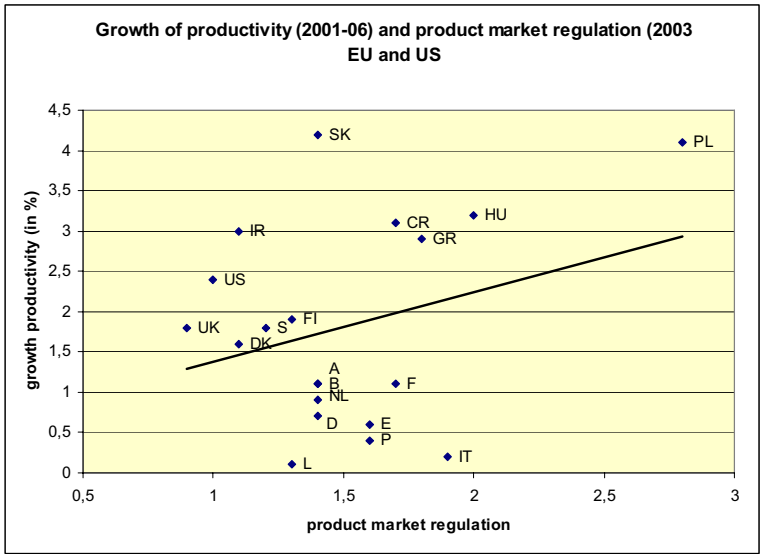
## Figure 7




**Regression analysis analysis:** Dependent Variable: GDP growth

| Variable | Coefficient | t-Statistic |
|---|---|---|
| C | 2.178 | 1.99 |
| Product market regulation | 0.220 | 0.31 |
| R-squared | 0.005 | |

## Figure 8




**Regression analysis**: Dependent Variable: Growth Productivity

| Variable | Coefficient | t-Statistic |
|---|---|---|
| C | 0.519 | 0.50 |
| PR | 0.860 | 1.289 |
| R-squared | 0.084 | |

There is a potential for a bias due to omitted variables in the little empirical exercise of figures 7 and 8. In particular, the new EU-member states have a low level of development. This may be associated with higher product market regulation. In order to eliminate this bias I regressed the two growth indicators on the PMR-index and the initial level of GDP per capita (YCAP). The results are shown in table 1.

**Table 1**

Dependent Variable: GROWTH of GDP

| Variable | Coefficient | t-Statistic |
|---|---|---|
| C | 11.99 | 2.28 |
| PR | -0.91 | -1.03 |
| YCAP | -1.80 | -1.90 |
| R-squared | 0.18 | |

Dependent Variable: GROWTH of PRODUCTIVITY

| Variable | Coefficient | t-Statistic |
|---|---|---|
| C | 15.89 | 4.00 |
| PR | -0.92 | -1.37 |
| YCAP | -2.81 | -3.95 |
| R-squared | 0.52 | |

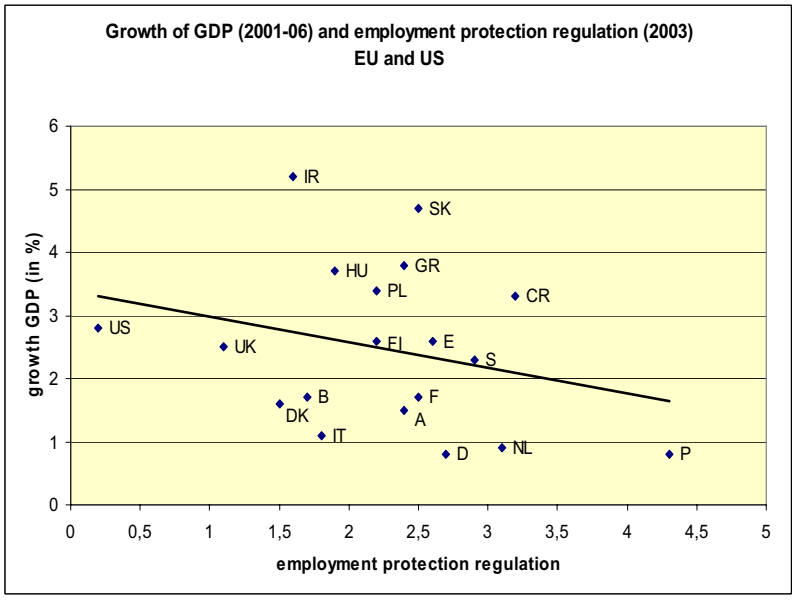
Note: The variable YCAP is expressed in logarithms.

We find that the coefficient of product market regulation now has a negative sign, but is not statistically significant. Note also that the inclusion of YCAP increases the explanatory power of the regression a lot.

We perform a similar analysis relating the growth performance of our sample of countries since 2001 to the degree of labour market regulation. The MRBC-theory tells us that labour market rigidities are an important explanatory variable explaining the growth decline in the eurozone. The mechanism is that regulated labour markets reduce the efficient use of labour and thus lower the potential for growth. Is there any evidence for this? Put differently, is the degree of labour market rigidities a good predictor of how individual countries weathered the slowdown in economic growth after 2001?

In order to answer this question we use the OECD measure of employment protection. It is described in appendix. We relate our two measures of growth performance (GDP-growth and productivity growth) to this index. We also perform a regression analysis including the initial levels of per capita GDP (see table 2).

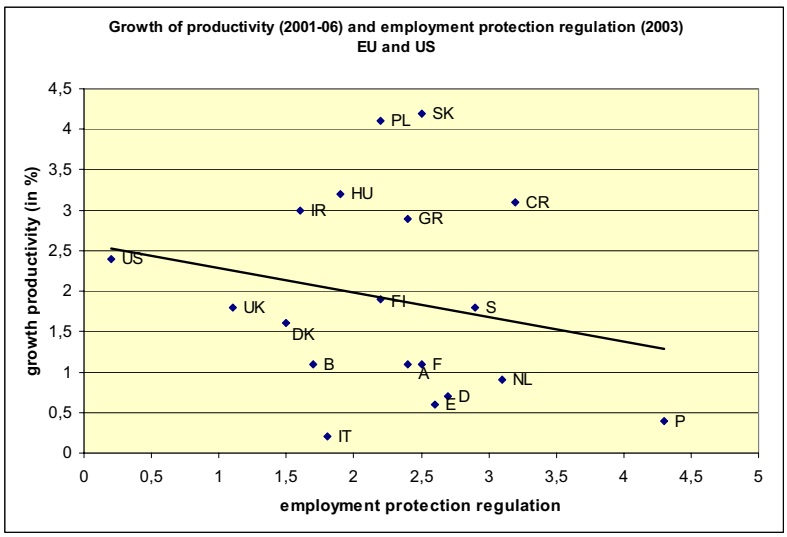
**Figure 9**




Dependent Variable: GDP

| Variable | Coefficient | t-Statistic |
|---|---|---|
| C | 3.389 | 4.08 |
| ER | -0.406 | -1.18 |
| R-squared | 0.075 | |

**Figure 10**



| Dependent Variable: Productivity growth | | |
|---|---|---|
| Variable | Coefficient | t-Statistic |
| C | 2.581 | 3.24 |
| ER | -0.302 | -0.91 |
| R-squared | 0.047 | |

**Table 2:**

| Dependent Variable: GDP growth | | |
|---|---|---|
| Variable | Coefficient | t-Statistic |
| C | 14.63 | 4.25 |
| ER | -0.754 | -2.58 |
| LGDPCAP | -2.346 | -3.33 |
| R-squared | 0.45 | |

| Dependent Variable: Productivity growth | | |
|---|---|---|
| Variable | Coefficient | t-Statistic |
| C | 15.85 | 5.97 |
| ER | -0.712 | -3.16 |
| LGDPCAP | -2.768 | -5.09 |
| R-squared | 0.63 | |

We now find that the labour market rigidities have a significant negative effect on the growth performance in our sample of countries (see table 2). The quantitative importance of rigidities in explaining growth performance, however, is weak. Most of the explanatory power comes from the inclusion of the initial per capita income. The weak quantitative importance of labour market rigidities in explaining growth performance can also be seen from figures 9 and 10. Take figure 10. We observe that the low productivity growth countries with similar per capita income (Belgium, Germany, France, Netherlands, Italy, Spain) have very different levels of employment protection. Similarly, countries with similar levels of employment protection (Ireland, Denmark, Belgium, Italy) experience very different productivity growth. And these are countries with similar levels of per capita income.

We conclude that the low growth performance of the eurozone countries cannot easily be explained by the existence of product market and labour market rigidities. Additional explanations are necessary. These have to do with different demand

developments in these countries that in turn are related to national idiosyncracies, e.g. different fiscal policies, different wage policies, and different "animal spirits".

## 8. The institutional weakness of the present Eurozone Governance

The present institutional design of the Eurozone is weak. This weakness manifests itself both at the level of fiscal policies as at the level of monetary policies.

In the Brussels-Frankfurt consensus, the Stability and Growth Pact (SGP) is seen as the cornerstone of the governance of fiscal policies in the Eurozone. As argued earlier, the proponents of this view see the SGP as the necessary fiscal framework providing long run sustainability of national fiscal policies. In so doing, the SGP makes a stability oriented monetary policy of the ECB possible while at the same time providing sufficient flexibility for national budgetary authorities to accommodate for asymmetric shocks.

The SGP, however, is built on a weak institutional foundation. The reason is the following. As argued earlier, spending and taxation are still very much the responsibility of national governments and parliaments. That is also the level at which democratic legitimacy is vested. As a result, these spending and taxation decisions are backed by an elaborate process that is deeply embedded in national democratic institutions.

The SGP now imposes top down an extensive control and sanctioning system on the net effect (budget deficit) of this democratic decision making process by institutions that are perceived to lack the same democratic legitimacy. Lawyers will undoubtedly object that the SGP is the result of a Treaty that has been ratified by the same democratic institutions, the national parliaments, so that it has the same legitimacy as the national parliaments. This is undoubtedly true from a legal point of view. It is not from a political point of view.

When the Commission starts an excessive deficit procedure which aims at forcing national governments to cut spending and/or increase taxes, it bears no political responsibility for these decisions. In fact, the national governments do. When these follow up on the Commission's procedure and cut spending and raise taxes they are the ones who will be judged by their national electorates, and who face the threat of being punished by the voters at home. In contrast, the European Commission at no

time faces the prospect of being voted away. Thus from a political point of view, the European Commission, which initiates the control and sanctioning procedure of the SGP, lacks democratic legitimacy, because there is no mechanism to make the Commission accountable before an electorate for its actions.

This lack of accountability of the Commission makes the SGP unsustainable. Each time a conflict arises between the Commission and the national governments, the former is bound to loose. This is also what has happened in November 2003 when France and Germany disregarded the SGP. It will happen again when conflicts arise between the Commission and the national governments. Thus, it can be concluded that the SGP is a fragile institutional construction that is unlikely to lead to its objective.

This problem will continue to exist as long as the nation-states maintain their sovereignty over spending and taxation, and as long as those who decide about spending and taxation are made accountable for decisions before a national electorate.

A similar institutional weakness exists at the level of monetary policies. The Maastricht Treaty has defined the objectives of the ECB. The primary objective is price stability. The Treaty, however, adds that if price stability is not at risk, the ECB should pursue other objectives, in particular, sustaining economic activity.

The ECB has filled out the fine print of its mandate by essentially dropping the requirement that it should pursue other objectives than price stability. It has done so using the monetarist-real-business-cycle theory and claiming that by focusing on price stability it automatically guarantees that the other objectives mandated in the Treaty are fulfilled.

In addition, the ECB has given a practical content to the objective of price stability by defining this as a rate of inflation below (but close to) 2%. Without asking permission, the ECB has absolved itself from any responsibility about unemployment. It has relegated this responsibility to the national governments. It has done this using the wisdom of an academic theory, the empirical evidence for which is still being debated. As a result the rest of society is not convinced and will not easily accept the attempt of the ECB to extricate itself from any responsibility about unemployment.

In addition, by relegating the responsibility of unemployment to the national governments it creates a political problem that is similar to the problem identified

with the SGP. If national politicians have to bear the sole responsibility for unemployment, it is only natural that they will want to use all available instruments to fight unemployment. The claim that all they have to do is to introduce "structural reforms" (whatever that means) will not solve the problem because there is more to unemployment than the structural component. The lack of instruments, both monetary and budgetary, to fight the cyclical component of unemployment will lead national politicians to the temptation to use these instruments because these politicians will be made accountable before national electorates when they fail to lower unemployment. One cannot maintain a political system where national politicians are made fully responsible for unemployment while key instruments to deal with this problem have been taken away from them, and are held by those who do not want to be made accountable for this problem.

The conclusion is that either one gives those who are bearing the burden of political accountability for unemployment the full panoply of economic instruments, or one transfers at least part of the political accountability for this problem to European institutions, including the ECB.

## 9. On the need for further political integration

In the preceding sections we have argued that there is a deep problem of governance in the Eurosystem. We identified three problems. First, important instruments of macroeconomic policy (monetary policy and the management of the government debt and deficits) have been transferred to European institutions. However, the political accountability for the results of the decisions taken in these fields is still vested with national governments. This creates a tension that is bound to be won by national governments.

Second, the Eurozone lacks a system of redistribution that will compensate those who are hit by a negative shock. These negative shocks, quite surprisingly, have remained large within the Eurozone. One cannot simply tell those countries faced by such a shock that they should solve the problem on their own. A redistributive system is essential to create an "allegiance" to the union, which in turn is important to maintain its sustainability.

Finally, the fact that large areas of economic policies remain in the hand of national governments create asymmetric shocks that undermine the sustainability of the monetary union. In particular, the use of uncoordinated national wage policies leads to divergent trends in the competitive positions of the member countries of the eurozone. This in turn leads to a vicious circle in which each country tries to recover its competitive position by wage cuts, leading to deflationary spiral. Not only wage policies have remained in the hands of national governments, the whole of social policies together with the structural reform processes are national affairs. These create a potential of structural divergences between member states leading to diverging trends in output and employment.

These three problems call for further steps towards political union. Without a political union the Eurozone is at risk. The previous analysis allows us to describe how such a political union should look like.

A first element of such a political union is a certain degree of budgetary union, giving some discretionary power to spend and to tax to a European executive, backed by a full democratic accountability of those who are given the authority to spend and to tax. This will allow setting up an insurance system against asymmetric shocks in the Eurozone. This can take many forms, and several proposals have already been made (see e.g. Mélitz and Vori(1993), Von Hagen and Hammond(1995)). The transfer of budgetary power does not have to be spectacular as was shown by the previous authors. Nevertheless, it will require a European budget that increases significantly relative to its present level of about 1% of GDP.

Second, an increased institutionalized coordination of a number of economic policy instruments that have macroeconomic consequences will be necessary. We have mentioned social policies (including structural reform policies) and wage formation. The need to coordinate does not imply that these areas should be fully centralized. Rather it means that spillover effects of decisions in these areas into the monetary union should be internalized. Thus, decisions like cutting the working week in France which have obvious implications for the Eurozone as a whole should be a matter of common concern, and should not be allowed to be decided by individual countries without consultation with other countries. Similarly, national wage policies will have to be coordinated in order to avoid asymmetric developments in competitive positions of the member countries.

Third, accountability of the European institutions that today take major decisions at the macroeconomic level will have to be improved significantly. This includes the ECB, an institution that singularly has managed to escape any serious degree of accountability. Improving accountability of the ECB also implies that the definition of the objectives of monetary policy should not be left to the sole judgment of the ECB, as it is today. The definition of the objectives of the central bank belongs to the political sphere. It is not just a technical problem that the ECB alone decides about. It also follows that the independence of the ECB should be restricted to instrument independence, much in the same way as this is done today in major countries in the world, such as the UK, the US and other industrialized countries. This means that once the objectives have been defined by accountable politicians, the central bank should be left free to pursue a policy that leads to these objectives.

In this connection a redefinition of the inflation target will be important. It appears today that the inflation target pursued by the ECB is too tight. A target setting inflation at maximum 2% per year makes it very difficult for countries that have lost competitiveness to restore it without great losses in terms of output and employment (see Sinn and Reuter(2001) on this). A target of 3% would make this equilibration process easier. In a way it can be said that the present low target introduces rigidities in the Eurosystem. Raising the target is equivalent to introducing greater flexibility, which is the dream of central bankers.

## 10. Conclusion

We have argued in this paper that the long run success of the Eurozone depends on the continuing process of political unification. Such a political unification is needed to reduce the scope for the emergence of asymmetric shocks and to embed the Eurozone in a wider system of strong political ties that are needed to take care of the inevitable divergent economic movements within the Eurozone. In addition, such a political union is necessary to deal with the flaws in the governance of the Eurozone. The major flaw is that while national politicians continue to bear the full political responsibility for unfavourable trends in unemployment, key instruments to deal with this problem have been taken away from them and have been transferred to European institutions that bear no political responsibility for their decisions.

The recent no votes concerning the European constitution signal that there is a strong "integration fatigue" in the European Union today, making it unlikely that significant progress in political unification can be made. This will continue to make the Eurozone a fragile regime. In the long run, however, there can be little doubt: without further steps towards political union the Eurozone has little chance of survival.

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## Appendix: Indicators of Product Market Regulation (PMR)

***The PMR indicators***

***Scope of public enterprises***: this indicator measures the pervasiveness of state ownership across business sectors as the proportion of sectors in which the state has an equity stake in at least one firm.

***Size of public enterprise***: reflects the overall size of state-owned enterprises relative to the size of the economy.

***Direct control over business enterprises***: measures the existence of government special voting rights in privately-owned firms, constraints on the sale of state-owned equity stakes, and the extent to which legislative bodies control the strategic choices of public enterprises.

***Price controls***: reflects the extent of price controls in specific sectors.

***Use of command and control regulation***: indicates the extent to which government uses coercive (as opposed to incentive-based) regulation in general and in specific service sectors.

***Licenses and permits systems***: reflects the use of 'one-stop shops' and 'silence is consent' rules for getting information on and issuing licenses and permits.

***Communication and simplification of rules and procedures***: reflects aspects of government's communication strategy and efforts to reduce and simplify the administrative burden of interacting with government.

***Administrative burdens for corporations***: measures the administrative burdens on the creation of corporations.

***Administrative burdens for sole proprietors***: measures the administrative burdens on the creation of sole proprietor firms.

***Sector-specific administrative burdens***: reflects administrative burdens in the road transport and retail distribution sectors.

***Legal barriers***: measures the scope of explicit legal limitations on the number of competitors allowed in a wide range of business sectors.

***Antitrust exemptions***: measures the scope of exemptions to competition law for public enterprises.

***Ownership barriers***: reflects legal restrictions on foreign acquisition of equity in public and private firms and in the telecommunications and airlines sectors.

***Tariffs***: reflects the (simple) average of most-favoured-nation tariffs.

***Discriminatory procedures***: reflects the extent of discrimination against foreign firms at the procedural level.

***Regulatory barriers***: reflects other barriers to international trade (*e.g.* international harmonisation, mutual recognition agreements).

Source: Conway, P., Janod, V., Nicoletti, G., (2005)

**Indicators of employment protection for regular employment:**

- Regular procedural inconveniences
- Notice and severance pay for no-fault individual dismissals by tenure categories
- Difficulty of dismissal Procedures
- Delay to start of notice
- Notice period after Severance pay
- Definition of unfair dismissal
- Trial period before eligibility arises
- Unfair dismissal compensation
- Extent of reinstatement

Source: Conway, P., Janod, V., Nicoletti, G., (2005)