Debacle in the Euro Zone

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The following was presented in 2001. It anticipates many aspects of the current euro debacle.
• In 1945, in the immediate aftermath of World War II, Winston Churchill proposed a ‘United States of Europe.

• EMU is rooted in the notion of European integration and the desire of European nations to prevent a re-occurrence of war on the continent.

• The guiding principles of the EMU have always been political rather than economic.
THE EU 15 on January 1, 1999

IN Euroland
• Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain (11)

OUT of Euroland
• The UK, Sweden and Denmark were invited to join, but declined (3)
• Greece wished to join, but was not invited (1)
Optimum currency areas - theory

• The theory is due to Robert Mundell
• **Costs** of a single currency –
  – loss of flexible exchange rates to correct trade imbalances
  – real sector adjustments are necessary
• **Benefits** of a single currency
  – Lower transaction costs
• In an optimum currency area
  Costs < Benefits
Effects of currency union

• Removal of intra-union currency uncertainty and lower transaction costs

BUT

• Member states lose control of monetary policy

• Main policy instruments that are lost:
  – Money supply
  – Interest rates
Optimum currency areas – requirements

• The basic implication is that in optimum currency areas
  – the need for real exchange rate dynamics is low – you don’t need to adjust exchange rates
  – it is possible to make policy corrections in response to macroeconomic shocks – you can easily transfer wealth from one region to another
Requisites for low exchange rate dynamics

1. High factor mobility – labor and capital
2. Similar sectoral economic structure
3. Similar pattern of business cycles
4. Price and wage flexibility
5. Similar inflation rates
6. Diversified product markets
7. High relative level of intra-area trade
Policy tools needed to make a single currency work

1. **Fiscal integration**: Fiscal transfers from one region to another to offset the effects of divergent shocks

2. **Policy integration**: Similar monetary and fiscal priorities

3. Similar levels of economic development, so that fiscal transfers are not excessive
The EU – an optimum currency area?

• Intra-EU labor mobility – poor

• **Business cycles** –
  – ‘the DM club’ of Germany, Austria and Benelux are convergent; the UK follows the US cycle; Latin Europe is on its own cycle

• **Wage and labor market flexibility** – poor

• **Inflation rates** – North (low) vs. South (high)

• **Intra-EU trade** – Benelux > 60%, Spain 17%, EU average 35%.
Implications

• There is a single ‘one size fits all’ monetary policy’
• In practice this may be set for the major EU economies – Germany, France, Italy
• As countries find themselves in affected differently by real shocks, policy that is right for some will be wrong for others
• Interest rates and exchange rates are no longer available as automatic stabilizers
The lure of the US model ...

In the US, regional shocks lead to

• Substantial wage adjustment
• Massive Labor migration (e.g., 1991 recession in California)
• Fiscal offsets (lower regional income means lower federal tax liability)
  – The fiscal offset has been estimated at 30% in the US compared to 1% in the EU
But the Italian model is probably more realistic

- Structural differences between the North and the Southern ‘mezzogiorno’
- Single currency prevents devaluation and interest rate adjustment in the South
- Along with poor wage flexibility this implies
  - a high Southern unemployment rate
  - widening disparity between North and South
  - huge fiscal transfers from North to South
Insert Greece (or another Mediterranean country)

• The Greek budget woes stem, in the main, from an inability of the Greek state to collect taxes to pay for public goods

• The deficits have cascading effects on other European economies through their unbreakable “euro” connection

• “German taxpayers must pay for Greek benefits” – fiscal transfers on a massive scale