

Current Imbalances and Main Adjustment Mechanisms in the European Monetary Union

Gheorghe Matei¹, Luiza Apostol²

¹ University of Craiova

² University of Pitești

ghematei@yahoo.com, lm.apostol@yahoo.com

Abstract: *The adoption of the euro as a common currency in 17 of the 27 member states of the European Union was achieved in a process that did not strictly observe the recommendations of the economic theory of an optimal monetary area. The elimination of exchange rates before the establishment of European Monetary Union represented the renunciation of an automatic macroeconomic stabilization mechanism and generated major commercial and financial imbalances between the countries in the Eurozone. The emergence of the financial crisis in 2008 combined with the lack of mobility of the labor at European level and the lack of fiscal reforms in the less competitive countries led to the current situation of the unsustainable public debts. The measures envisaged with the purpose to address this crisis are different in terms of level of assistance the competitive countries have to give to the others, the duration and value of wealth transfers that should be made between the states and the limit from which they will affect the fundamental stability and prosperity policy objectives of the European project.*

Keywords: single currency, fiscal imbalances, fiscal integration, financial crisis.

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1. Introduction

The process of political and economic unification in Europe was determined not only by aiming at achieving economic prosperity but also by achieving a durable stability on the continent. The current financial and fiscal crisis calls in question these achievements because it reveals a policy conflict in relation to the operation of the European institutions and may jeopardise the very continued existence of the single currency. In this moment, the institutions must be reformed in a manner in which the economic integration itself should not become a source of policy conflict among the member states.

Recent papers, among which the one by P. Krugman (2012), suggest that the process of monetary unification in Europe was based on the unrealistic beliefs of the European leaders who deliberately chose to ignore the warnings issued by the economic theory.

The current problems of the Eurozone seem to confirm this unpleasant perspective and raise the question whether and to what extent the current leaders of the national countries agree with reforming their own administrations and to allocating additional national resources with the purpose of maintaining the coherence of the monetary union.

2. Essential imbalances of the European Monetary Union

The European unification process started with the creation of a common market with the purpose of allowing member countries to benefit from the economic advantages of the free trade and from the availability of the production factors in Europe.

Nevertheless, the fundamental policy objectives are not automatically guaranteed by a deeper economic integration given the major economic imbalances among the national economies.

An important step within the European project was the adoption of the single currency for the completion of the economic unification process by eliminating currency barriers in the Eurozone and by creating a more liquid and integrated capital market, as well as by guaranteeing the stability of prices at European level.

The implementation of the single currency was a decision to renounce the national independent monetary policy and by transferring the responsibility related to the stability of prices to the European Central Bank (ECB). This measure has also eliminated the system of the exchange rates among the countries, a key mechanism for the avoidance of translational commercial and financial imbalances, which can come after the external competitiveness divergences of the member countries of the Monetary Union.

According to the economic theory developed by Mundell (1961) and Kenen (1969), the smooth operation of the common currency implies that the independent exchange rates are replaced by other adjustment mechanisms, on the one hand institutional and macroeconomic (mobility in the common space of the production factors) and on the other hand the fiscal one (the unification of the budgetary resources of the member countries). A systematisation of these papers has been made recently by Paul De Grauwe (2009) who lists four such adjustment mechanisms: (i) the flexibility of salaries in the national economies with the purpose of providing international competitiveness; (ii) labour mobility within the monetary union; (iii) the centralization of the fiscal institutions with the purpose of providing an insurance against asymmetric shocks, and (iv) strict fiscal rules for the prevention of the negative collateral effects of the national fiscal policy in other member countries.

The currently noticed imbalances show, however, that none of these four conditions required for the optimal functioning of the European economies seems to have been met.

Few member countries have reformed their institutions on the labour market in order to allow for sufficient salary flexibility, which could compensate the absence of the exchange rate as adjustment mechanism. For a non-competitive economy, this would have meant a devaluation of its currency, making the exports of such country cheaper on the world markets and imports more expensive, allowing the respective country to follow a sustainable income growth path in line with the national productivity. While Germany went through an extended period of salary moderation and painful reforms on the labour market (the Hartz reform), Greece, Portugal, Spain and Italy remained behind. Their inflexible labour markets and the rigidity of the nominal salaries prevented the adjustment required in these economies.

The divergent trends of the unitary salary costs in Europe seem to be the most important problem at the level of the monetary union. Eventually, these persistent differences cause big commercial imbalances, leading to the accumulation of net foreign debt of the weak countries from the southern outskirts and net external claims of other countries that are more competitive, such as Germany.

Moreover, due to cultural and language barriers, the labour mobility among the countries tends to be low in Europe and is manifested to an extent that could significantly reduce unemployment among the Eurozone countries or generally change the conditions in the labour market.

The increase in the unit salary costs in the countries of the south of the continent was, however, partially induced, in the period of the current financial crisis, by a dysfunction of the capital market. Initially, with the implementation of the single currency, by the elimination of the risk premiums and the spectacular increase of investments in Southern Europe, the difference between the interest rates in the Eurozone the differences compared to Germany largely disappeared. The capital in flux and its low cost facilitated the increase in the salary costs within these national economies, which growth was not supported by a long-term productivity increase.

When the interest rate differences occurred again in recent years and the cost of the borrowed capital increased, big part of the previously made investments no longer proved to become profitable. Even in the absence of the fiscal debt, the increase in the private external debt in the non-competitive economies occurs when the private sector borrows too much compared to its capacity to generate salary incomes and profits. In the absence of the exchange rate adjustment mechanism this situation is substantiated in the accumulation of external debts, independent of the deficits in the public sector. Due to the fact that the euro currency proved to be too strong for the economies with a low productivity, structural unemployment became very high and the profits remained low, thus making companies very vulnerable to adverse shocks. The increasing unemployment also increased social spending and reduced tax revenues from salaries. The low profits further reduced fiscal revenues and led to high business failure rates, which subjected the public sector to additional fiscal pressures with the purpose of recapitalizing important banks or companies in the private sector. In Spain and Ireland, for example, where the public debt was not excessive before the crisis, the occurrence of the events seems to confirm this hypothesis.

The failure of the financial markets in the optimal allocation of the capital within the European economies was boosted by the high vulnerability of the banking sector. The own equity capital standards for the European banks were and still are too low, which creates a systemic risk. Given the interdependence and the mutual lending in the banking sector, the failure of a bank threatens the survival of others.

Since a country cannot risk, in theory, the occurrence of a chain of bankruptcies in the banking sector, the only acceptable scenario remains that in which the credit institutions are eventually saved by the state.

In this case, the systemically important banks receive an implicit state guarantee, having access to cheap funds and, apparently, safely, which creates strong incentives to engage in risky lending operations. Such a strategy generates very high profits in good times and, until the occurrence of the financial crisis in 2008, it seemed to be the favourite working method of the most important banks on the continent. The implied guarantee provided to the banking sector largely facilitated excessive lending in the private sector and the government bonds issued by the governments of the less competitive countries.

The vulnerability of the system was revealed with the onset of the financial crisis, which crisis was largely caused by the somewhat forced implementation of the single currency (Krugman, 2012), when, in the absence of a European central treasury that should fulfil the function of lender of last resort, the banks that had previously invested massively in government bonds issued in the non-competitive economies had to resort to this implied guarantee granted by the status of systemically important financial institution. This led to the so-called “doom loops” in which the devaluation of the

portfolio of sovereign bonds required liquidity injections in the banking institutions with problems by the national authorities, thus increasing the public debt of the respective states and triggering an intensified worsening of the ratings of the bonds issued by them.

The accumulation of unsustainable debt, either in the private sector (Spain's case), or the public one (as in Greece or Italy), or as a result of the action of saving the banking institutions (Ireland's case) may trigger negative effects in several ways (externalities) on other member countries in the case of a monetary union.

From the point of view of all the other member countries of the monetary union, the negative externalities caused by the sovereign debt crisis is an obstacle in obtaining the earnings expected at the time of the European unification.

The most important negative externality is highlighted by the case when other member states, being more or less forced, have to contribute to the bailouts of another country which finds itself in a state of sovereign bankruptcy, with the purpose of preventing the negative consequences on its own financial stability. Given that in a common capital market at the level of the union, the creditors of a state found at the edge of bankruptcy are distributed in all the other member countries, the consequence of the initiation of this procedure would be the irreversible loss of wealth, the public authorities are forced to use their own financial resources in order to overcome this situation to improve as much as possible the position of the less stable nations.

Moreover, the government bonds issued by the countries with problems are anyway exposed to devaluation within the financial markets, the investors requesting substantial risk premiums for their trade, thus significantly altering the financial reserves of the initial creditors. If these crediting banks, pension funds, insurance companies or even private investors are themselves in a difficult situation, it is necessary for their respective countries to allocate their own budgetary resources for their salvation. Given the general problem of the under-capitalization of the European banking system, huge public resources are needed to protect those financial institutions deemed systemically important, leading ultimately to the worsening of the situation of their own financial securities in the capital markets

A second undesirable effect is the worsening of the own financial situation of the states unaffected by the sovereign bankruptcy risk as a result of the decrease of the available money and the increase in the refinancing interest rates within the common financial market, thus reducing the possibilities of investing and growth at the level of the whole monetary union. The increase in the interest rates corresponding to the public debt reduces the budgetary resources of the authorities of all the member states and leads to adopting sub-optimal fiscal policies at the expense of their own taxpayers.

Eventually, depending on the nature of the common monetary policy, the amounts necessary to finance both the public sector as well as the major private institutions could come from a substantial currency issuance, thus threatening the central objective of the European monetary construction, namely the stability of the prices. The emergence of the inflation as phenomenon generalized at the level of the whole monetary union would lead to the sharp devaluation of the economies and of the financial wealth, as well as of the overall level of the public and private debt in all the member countries and, consequently, in an uncontrolled redistribution from those who save to those with an unproductive economic behaviour, thus limiting investments and economic growth across the whole monetary union.

3. Potential answers

There are obviously several proposals for the limitations of the effects of the imbalances in the Eurozone, each of them involving either a direct transfer of resources from the most competitive countries to the distressed ones, or as a way to guarantee the solvency and economic performance of the latter.

The simplest solution discussed at European level is the one in which the European Central Bank commits to grant its own guarantee for the sovereign bonds issued by the member states on the international capital market. This would lead to a stabilization of the financial markets around acceptable interest rates for the refinancing of public debts but it is incompatible with the current status of ECB to guarantee the stability of the prices and not to get involved in financing public debts.

Moreover, resorting to ECB is not likely to stimulate the responsible financial behaviour and may even lead to the relaxation of the reforms initiated by the states with problems and to the further postponing of the consolidation efforts.

The recourse to the ECB guarantee by the investors holding bonds of some countries in a bankruptcy situation would be the equivalent of the uncontrolled currency issuance in the Eurozone, thus reducing the value of the single currency to the detriment of the powerful national economies and instantly cancelling their efforts toward increasing competitiveness in the international goods markets.

Moreover, the currency issuance or only the guarantee granted by ECB to the government bonds of the member countries would lead to the relaxation of the lending conditions in the financial markets within the monetary union, thus leading to the increase of the risk of generalized inflation, the main opponent of ECB according to its articles of incorporation.

The second proposal is the creation of Eurobonds jointly guaranteed by the member states in the Eurozone and evaluated by potential investors based on the economic capacity of the whole monetary union. In their simplest form, they should be available for all the countries in the Eurozone, the same interest rate, thus redistributing the refinancing capacity to the advantage of the weaker countries of the Eurozone and allowing the member states already over-indebted to access a cheap financing source without making the adjustments required for the optimal functioning in the monetary union.

In the opinion of certain economists as D.Stelter (2012) or D.Delamaide (2012), it is justified to take into account the option for the issue of common European bonds, despite the implied disadvantage given by the absence of reforms in the over-indebted countries, due to the magnitude of the current sovereign debt crisis, impossible to overcome only by appealing to the ECB or ESM (the European Stabilisation Mechanism).

Moreover, some authors view the Eurobond issuance as a way to turn the euro currency into a global reserve currency, thus providing a cheap long-term financing source as in the case of the U.S. dollar. In this case, among the beneficiaries of the bond issue there would also be countries viewed as competitive such as Germany, Holland or Austria, whose loans, given the reduction of the credit ratings of the countries lately, could be made at an even lower interest rate.

Despite the blocking at the political level of the European Union of the issue of common bonds, the economic literature has proposed lately several forms thereof, which should include either the limitation of the access of the member countries to the resources thus obtained, or their conditioning on the implementation of structural reforms that should lead to the reduction of the gaps among them with the purpose of

diminishing the requirement of financial transfers from the stronger countries to the latter ones.

These new types of bonds could be issued with the full or limited guarantee of the member states of the monetary union (the so-called blue bonds and red bonds) or within the limit of a relative ceiling of the gross domestic product or, ultimately, a combination of the above-mentioned conditions.

The introduction of Eurobonds as a source of financing the debt of EU member states remains controversial, their opponents arguing that the resources thus attracted will only increase the already existent gaps among the national economies, without touching the real problem, namely that of the competitiveness differences among them and without being an automatic macroeconomic stabilisation mechanism at the level of the Union.

The third way of addressing financial imbalances caused by the distressed countries involves resorting to public lending institutions, such as the European Financial Stability Fund (EFSF) later transformed into the European Stabilisation Mechanism (ESM), directly from the European Commission or the International Monetary Fund (IMF).

Given the recent establishment of the ESM as a permanent crisis resolution mechanism for the countries in the euro area by issuing debt securities in order to finance loans and other forms of financial assistance for the member countries of the euro area, it is appropriate, in our opinion, to refer only to it as a form of public lending institution.

Blocking the access of a member country of the monetary union to the financial markets by the unacceptable increase in the interest rates requested by creditors may lead it to obtaining more accessible loans that are nevertheless conditioned by EMS (or other public lending institutions). "Conditioning" means the implementation of a programme for the restructuring of the public policies with the purpose of restoring economic competitiveness and accepting a strict supervision by the credit institution for the compliance with it.

According to its articles of incorporation approved in 2012, EMS is authorized to use the following credit tools in favour of its members, subject to appropriate conditions: providing loans within a macroeconomic adjustment program; acquisition of the existing debt (government bonds) from the primary and secondary financial markets; granting preventive financial assistance in the form of credit lines; financing the recapitalization of financial institutions through loans to the governments of member countries of the EMS and direct recapitalization of the banks in the euro area, after establishing single supervisory mechanism effective in this regard.

The main advantage of financings through the EMS is that the necessary amounts cannot be obtained without applying a fiscal adjustment programme in the applicant countries. Thus, the debt refinancing and the reformation of the domestic economic system are implemented and supervised by the same institution. Moreover, EMS supplements the institutional framework of the European Union, being directly linked to other programs conducted in support of the convergence, of the economic and fiscal cohesion. EMS is therefore, by forcing the necessary adjustments in the economy of the member states, a particularly strong intervention tool with the purpose of providing the cohesion required for the functioning of the monetary union of the euro area.

It is not yet established whether the ESM will have the financial capacity required or the guarantee of the member states to cope with the fluctuations of the financial markets or if it will be able to contract large loans, necessary to big countries. In principle, the ESM will operate by attracting financial resources at accessible costs

from the capital markets given the guarantee provided by its members, to which their direct contributions will be added.

Due to need to quickly obtain substantial amounts with the purpose of supporting large countries, such as Spain or Italy, either in the case of speculative attacks on their bonds, or in the case of the occurrence of another event which may possibly unbalance the finance of such country, the ESM project is not, however, a substitute for a central bank with full powers.

Thus, it is yet to be investigated whether such collaboration under well-defined conditions, with the ECB, would enable the conduct of exceptional operations via the ESM that could lead to the short-term elimination of imbalances without compromising the macroeconomic objectives of the latter.

The more complex manner of addressing the macroeconomic imbalances of the euro area is the construction of a fiscal union on the structure of the current monetary union, because the pros and cons of this measure should be analysed, on the one hand, for the achievement of the policy objective envisaged at the elaboration of the European project, and at the same time, the economic advantaged and disadvantages both for tackling the current crisis and independently of it.

Under the Maastricht Treaty, national states ceded away the power to regulate in favour of the central bodies of the European Union, on the free movement of capital, labour and goods.

Contrary to the economic theory of the optimum currency area (The Optimum Currency Area Theory), the European Union adopted, upon its establishment, however, the principle of subsidiarity in the fiscal area, which implicitly establishes that the member states are sovereign in their own fiscal policies: the collection of taxes and contributions, the procurement of goods and services, regulating the behaviour of the private sector of the economy. (CEPR 1994).

According to economic theory (Oates, 1999), fiscal centralization of the state (federal) has obvious advantages.

First of all, the exploitation of economies of scale for the joint procurement of public goods and services leads to a more appropriate of the national resources. At the same time, fiscal centralization provides a certain protection in relation to the redistribution of the incomes among the members of the society care, which it its turn is an automatic mechanism for the stabilization of the fluctuations within the national economy, replacing to some extent the need for the provision of the labour mobility in the union.

The fiscal union facilitates, in addition, the process of coordinating the macroeconomic policies of stabilizing an economy threatened by external shocks, or the financial ones, or in the form of price changes on the international markets for certain resources.

On the other hand, the decentralized allocation of the public resources in its turn has theoretical advantages. It is considered that the decrease of the distance between taxpayers and the public authority leads over time to the increase in accountability of the latter and consequently, to the improvement of the political and social environment.

The decentralization favours the allocation of the public resources in agreement with the preferences and characteristics of the local economic environment, thus increasing the satisfaction of taxpayers and hence the ability of authorities to collect tax resources. The process of independent establishment and spending of these resources among separate public authorities may lead to the emergence of new fiscal policies, rules and tools, whose effectiveness can be compared among areas and copied by them.

Finally, the fiscal decentralization leads to the competition of the various levels of the public authorities with the purpose of obtaining own incomes, which process can help limit the excessive increase of the public sector within a community.

The fiscal union of the member states of the euro area however involves a certain revenue transfer among them, such as in the case of Germany during the reunification process. The transfers meant to diminish the revenue and welfare differences among the various areas are likely to generate political tensions among the European countries. Even within national states, the redistribution of public resources among areas is subject to political dispute, which may cause the emergence or amplification of regional separation forces, similar to those currently noticed in Belgium or Spain.

Even if such a scenario would provide the automatic and efficient stabilization of the European economy to external shocks and would represent a foothold in the fight against the current financial crisis, the fiscal union built on the model of a federal state with a robust central budget, it does not, however, address the fundamental competitiveness and fiscal accountability differences among the member countries.

Unlike large and permanent transfers specific to a federal state, the European Union may choose to improve the transient transfer system currently applied as structural funds meant to finance the improvement of the infrastructure and other investments, to increase the competitiveness of less developed economies within the European Union.

4. Conclusions

Resolving the sovereign debt crisis in Europe raises the question whether the development of the European project also took into account the cases when the component countries will have to renounce part of their national sovereignty and prosperity in exchange for economic benefits that fail to appear. The current situation generated by the implementation of the single currency, enhancing trade and financial imbalances among the member countries together with the impossibility of making the fiscal reform of the non-competitive countries led to the escalation of the public debts of the latter and the subsequent damage of all the other countries.

On the one hand, it is obvious that structural reforms are needed both at the level of weaker countries, with the purpose of correcting unsustainable structural reforms, as well as at the level of the whole monetary union with the purpose of providing bigger flexibility on the labour market.

On the other hand, the avoidance of the amplification of the current crisis and the increase of the level of cooperation and convergence require the implementation of mechanisms and institutions either to correct initial imbalances, or to subsequently eliminate their effects.

From the macroeconomic point of view, the fiscal union at the euro area level may be the best solution to avoid shocks such as those of the current sovereign debt crisis, as long as the performance of large and permanent transfers of wealth among the member states will not create tensions likely to affect their political union itself. Nevertheless, the fiscal union cannot eliminate the competitiveness imbalances occurred following the abandonment of the automatic mechanism of the currency exchange rates, but it would be designed to subsequently offset, by transfers of wealth from the more productive states to the ones lagging behind.

Currently, the attempt to build a fiscal union in the euro area should start from the analysis of the impact of cohesion funds on the competitiveness gain obtained by the beneficiary countries and the opportunity to increase it.

The amendment of the articles of incorporation of the European Central Bank with the purpose that it may function as a guarantor of sovereign debt of the member countries could defuse the current situation on the international capital markets, with the risk of devaluating the single currency, thus affecting the competitive countries.

Another way of eliminating the effects of the current crisis could be the collective financing of the countries in the union through the issue of Eurobonds. According to the level of participation and the possible conditionality required through treaties, the common bonds could be an incentive to reform national governments that are, more or less, the origin of the current difficulties.

In the short and medium term, the countries of the monetary union chose to rely on the operation of a new public lending institution, the European Stability Mechanism, established in order to attract resources from international financial markets and their distribution towards the distressed countries in exchange for the implementation of reform programmes. Given the limited capacity of the ESM, it is hard to believe that this is more than a temporary solution to the current crisis of the debts, without answering the questions raised by the fundamental problems of the Eurozone, i.e. the lack of flexibility of the labour market, of a central budget at the level of the central institutions of the monetary union and the coordination of the fiscal policies among the member countries.

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