Currency Union without a Political Union: Implications for the European Monetary Union

Mehdi Monadjemi
School of Economics
UNSW Business School
University of New South Wales

John Lodewijks
S P Jain School of Global Management

Abstract

Following the Greek Financial Crisis of 2015 there has been a reassessment of the net benefits to be derived from a Currency Union. Some observers are supporting a 'Grexit' strategy while others are looking at ways to mend the structural weaknesses of a currency union. This article follows this second approach and suggests some policy options that, without infringing on political sovereignty, may strengthen the Eurozone. In particular, the article reintroduces the concept of automatic stabilizers in a regional context.

Keywords: Sovereign debt, Euro zone, macroeconomic policy, automatic stabilizers

JEL Classification: F34, F36, F43

Introduction

A monetary union (MU) consists of a group of countries that use a single currency with a single central bank conducting monetary policy for the whole region. The European Monetary Union (EMU) is the most established monetary union that exists in the world. The United States may also be a MU if each state or region is considered a separate monetary entity. The difference between EMU and the United States is the existence of a political and fiscal union in the latter but not in the former. The idea of creation of a united Europe has been supported by politicians, philosophers and religious leaders since the Roman Empire. During the twentieth century, the costs of two wars, both in terms of human and non-human resources and the fear of its reoccurrence provided a stronger support for the establishment of a united Europe. In 1946 Churchill proposed planning for the establishment of a 'united states' of Europe. Altiero Spinelli and Jean Monnet were the first two active participants in planning of such a concept. The primary planning for the integration and the union of the European countries were implemented by Robert Schuman and Jean Monnet. After the presentation of the plan more counties expressed their willingness to join the European Community.

In 1962 the first plan for the establishment of a monetary union was announced by the European Community Committee in which the estimated period for completion was 9 years. However, very little progress was made for pursuing the 1962 plan because with the existence of the Bretton Woods fixed exchange rate system there was no urgent need in Europe for exchange rate stability. The Werner report was completed after the breakdown of the Bretton Woods system in early 1970s. The report suggested a three stage process for establishment of the MU, including stability of the exchange rate within limits, price parity for the commodities produced in the union and the creation of the European central banking system, similar to the Federal Reserve System in the United States. The purpose of this paper is to examine and evaluate achievements and short comings of the EMU during the last 16 years since the introduction of euro in 1999 as a prelude to the current Greek crisis. The European Monetary System (EMS) as a background to the introduction of the euro is presented in section 1. The theoretical issues are discussed in section 2. Implementation of monetary and fiscal policy is evaluated in sections 3 and 4. Some discussions of EMU debt crises is analysed in section 5. Section 6 introduces the Greek crisis. Section 7 suggests a way to deal with the structural weaknesses of the Eurozone. Concluding remarks are offered in section 8.

1. Some Historical Background

Based on Werner suggestions, the snake system of fixed exchange rates became in operation in early 1970s. In this system the fluctuations of the exchange rate was limited to 2.25 percent above or below the par value. The stagflation of the early 1970s forced many European countries to devalue their currencies outside of the set limits causing the breakdown of the fixed exchange rate system. After the snake system the EMS was designed to limit fluctuations of the exchange rate among eight members of the system. The initial members of the EMS were Germany, France, Italy, Netherlands, Denmark, Luxemburg, Ireland and Belgium. The system was successful in keeping the rates of inflation in member countries in line with the rate of inflation in Germany, the country with the lowest inflation in Europe. In Figure 1 the inflation differential of 7 members of EMS with Germany is plotted. The differentials from the high levels in the 1980s reached almost zero (except Italy) in the early 1990s. Britain joined the EMS in early 1990s. The EMS remained in operation until 1992 when a speculative attack caused a significant depreciation of the British Pound and an increasing limit of fluctuations to ± 15 percent automatically caused the breakdown of the system. Finally Britain and Italy left the EMS and the European Monetary Union (EMU) with 12 original members was established and the single currency was circulated in 1999.[1]

The Maastricht Treaty suggested different stages for the eventual establishment of the EMU and the Stability and Growth Pact proposed the following economic criterion for entry of countries into the EMU:

1. Maximum budget deficit of 3 percent of GDP.
2. Maximum government debt of 60 percent of GDP.
3. Inflation not exceeding by more than 1.5 percent of the average of the three lowest inflation countries in the union.
4. Long term interest rate not exceeding more than 3 percent of the average interest rate of the three lowest inflation rates in the union.

These requirements allow potential members to enter the union with a stable and uniform economic condition. Currently the EMU has 19 members. An additional 7 members were admitted under the EMU stage 3.[2] The following table based on the European Commission Convergence report shows Maastricht entry requirements for the European Union in January 1999. United Kingdom, Denmark and Sweden chose to remain in the European Union but not to join the EMU. Entry requirement values are listed in the last row of the Table 1. Greece was the only country that did not meet three of the entry requirements. Greece was admitted later in 2001 on the basis of making satisfactory improvement for reaching the required values. There were 8 countries that did not satisfy the public debt requirement but were admitted by the European Commission ruling.

2. Theoretical Discussions

The theoretical background of EMU is based on optimum currency areas (OCA) which was developed in Mundell (1961). OCA depends on symmetry of the business cycles, capital and labour mobility. If these two conditions hold and trade between regions is high, benefit of having a fixed exchange rate exceeds its costs. To elaborate, suppose Sweden is a potential new member to the monetary union. The benefits of having a single currency are savings on the conversion of currencies and lack of uncertainty about fluctuations of the exchange rate and saving on costs of hedging and forward purchase of currencies. The higher is the level of trade between the potential member and the union, the higher are the benefits of joining the union. The costs of becoming a member of the union are the lack of exercising an independent monetary policy and the loss of exchange rate as a stabilizing mechanism. Suppose there is an adverse aggregate demand shock in the monetary union causing depreciation of the common currency against currencies of the non-members which compensates for the fall in aggregate demand. This gain is significant if there are high trade with non-members. In addition, within the union, prices fall in depressed areas causing an increase in exports. The higher is the trade between members; the larger is this benefit for the depressed areas. If labour mobility is high, labour moves from the depressed regions to the more prosperous areas causing lower unemployment in the depressed regions. Similar argument can be used for capital mobility causing equality of the rate of return on capital.

[1] The 12 original members of the EMU were Germany, France, Italy, Spain, Portugal, Finland, Ireland, Austria, Luxemburg, Greece, Netherlands and Belgium.

[2] These 7 additional counties are Cyprus, Malta, Estonia, Latvia, Lithuania, Slovakia and Slovenia.

The loss of an independent monetary policy may not be so great if business cycles of member countries are symmetric. If business cycles are symmetric, the same monetary policy strategy can be applied to all of the member countries. Monadjemi et al [2012] showed that business cycles of Germany and France and Germany and Italy are more Symmetric than business cycles of Germany and Greece and Germany and Spain.[3]Krugman and Obstfeld (2009) introduce the level of integration as the sum of trade, labour mobility and capital mobility. OCA is a particular level of integration where gains and costs of joining a monetary union are equal. At any higher level of integration benefits exceed costs and a potential member is better-off to join the monetary union. In Krugman and Obstfeld [2009] the optimum level of integration is not stationary; it could change at each level of integration as a result of changes in costs and benefits. Alesina and Barro (2002) show that joining a monetary union with a committed anchor benefits from price stability against the cost of not being able to exercise an independent monetary policy. The benefits are maximized for small, not well managed monetarily, countries having high trade with a large partner whose business cycles are symmetric with the smaller country.

3. Monetary Policy and Asymmetric Shocks

Under the fixed exchange rate systems such as Bretton Woods or EMS, the monetary policy of the member states is determined by the monetary policy of the dominant country. The US influenced the monetary policy of other countries under the Bretton Woods system and Germany performed the same task under the EMS. This occurred because smaller members attempted to keep the exchange rate fixed relative to the exchange rate of the dominant member. In a monetary union the task of conducting monetary policy for the whole union must be left with an independent central bank. If each central bank is allowed to conduct their own monetary policy, high inflationary countries attempt to print large quantity of common currency causing high inflation and monetary mismanagement in the whole union. The European Central Bank (ECB) conducts monetary policy for the whole union and prints money which is circulated in the member states. The board of governors of ECB is in Frankfurt and consists of governors of the central banks of each member state. The interest rate set by the ECB applies to all of the countries in the union irrespective of their existing economic conditions. Symmetry of business cycles is important in setting interest rates. A country in recession and depressed economic activity needs a low rate of interest whereas countries with high inflation prefer higher interest rates for price stability. In addition, countries accustomed to high inflation and high interest rates, are encouraged to borrow heavily when confronted by a low interest rate set by the ECB. This issue is discussed later as one of the causes of debt crises in some of the members of the EMU.

Price stability is the prime objective of the ECB and it conducts monetary policy based on inflation targeting. The ECB has been successful to keep inflation in member states at a low level and even creating deflation during the last months of 2014 and early 2015. The ECB operates similar to the Federal Reserve System in the United States, with the exception of the lender of last resort. The individual member states cannot borrow from the ECB if they experience shortage of liquidity. The ECB doesn't print money to finance budget deficits of individual members. Countries with deficits borrow from the other members of the union. Being a member of EMU is like being in straight jacket as the tasks of money printing and influencing the exchange rate is taken away from the individual central bank. In the EMU nations facing asymmetric shocks will have difficulty to respond to the shock because conducting monetary policy and depreciating the exchange rate is not possible. Furthermore, unlike United States, labour mobility is low in Europe. Unemployment remains high in depressed countries as the unemployed are generally reluctant to move to other regions of the union.

4. Fiscal Policy

Each member state in the EMU is fiscally independent. Revenues and expenditures of member states are set by the national governments based on internal economic situations, social welfare system and infrastructure expenditure. Unlike monetary policy, budget deficits of various members are widely different. In table 1 budget deficits as percentage of GDP are highest in France, Germany and Italy and lowest in Ireland, Denmark and Luxemburg. As mentioned earlier budget deficits are financed by borrowing from the other countries. Table 1 shows that public debt as a percentage of GDP is highest for Greece, Belgium and Italy. When Greece joined the EMU in 2001, it was able to borrow long term at the same interest rate as German borrowers.

[3] Symmetry of business cycles was examined using partial coefficient of correlation of growth and inflation between Germany and the other 4 countries.

Entering the EMU permitted members to borrow and consume more than they were accustomed to before joining the union. As a result borrowing countries accumulated heavy debts from the banks in other parts of Europe. These developments led the affected counties to experience persistent current account and budget deficits. This is reflected in Greece with its high wage bill of the public sector, the generous pension and early retirement age, the expensive education and health system without satisfactory outcomes, and the very low tax compliance with substantial understating of income without forceful penalties. Figure 2 shows that average sovereign debt in 2008 - 2010 as a percentage of GDP was higher in all of the 12 members of the EMU except Belgium, Finland and Spain. This rise is partly attributed to governments responding to the 2007 - 2009 financial crises. In general, high budget deficits coupled with low economic growth inside the straight jacket of monetary union have been blamed for the rising sovereign debt of the EMU periphery members particularly, Greece, Portugal, Spain and Italy.

5. Debt Crises in EMU

Debt crises in the EMU started in mid-2007 when some member states such as Greece, Portugal, Italy, Spain and Ireland reported public debts much larger than the limit set by the Stability and Growth Pact. This problem still continues today with Greece on the verge of default and perhaps exit from the EMU. Aside from low interest rates in some members of EMU encouraging them to over-borrow and spend excessively on social welfare expenditure, the EMU is an economic union without a political union. Unlike the United States where there is a cross subsidies among the states, no such arrangement exist among the members of the EMU. Countries experiencing large budget deficits do not expect funds to be transferred to them from the other countries with budget surpluses. Additionally, because of the financial crises of 2007 – 2009, the growth rates of the EMU countries have declined significantly. Growth rates of 4 EMU with heavy public debts are plotted. Starting in 2009, during the great financial crises, all 4 countries experienced a sharp drop in their rate of growth with Greece showing highest negative growth followed by Portugal and Spain.

The debt crises of EMU peripheries that started in the mid 2007 was intensified by negative growth rates in the latter parts of the decade and led to some like Greece to fail their international debt obligations.Rogoff and Reinhart (2008) argue that the substantial rise in government debt is mostly due to sharp decline in tax revenue and, in many cases, significant rise in government spending to eradicate the recession. They believe that bank bailout costs are, in many cases, only a small part of the post–financial crisis rise in debt burdens. Dreger and Reimers (2013) argued that as a result of recession after the financial crises of 2008-2009, declining government revenues together with rising government spending to save venerable financial institutions led to a sharp rise in public debt in the affected countries. The rapid rise of sovereign debt in Europe threatened the stability of the EMU. Although the EMU debt crisis started in the periphery, larger countries such as Italy and Spain have also been affected. In this study the authors examined the nonlinear relationship between the debt-to-GDP ratio and real per capita GDP growth for members of the EMU as well as a set of industrial countries. The negative impact of the debt-to-GDP ratio is limited to the members of the EMU during periods of non-sustainable sovereign debt. Furthermore, the results of the study suggest that being a member of the EMU may introduce additional risk. Feldstein (2011) and Eichengreen (2007), suggested that creation of a fiscal union with a common liability for national debt may be a reasonable path to resolve the EMU's debt and deficits crises.

6. A Greek Tragedy Averted?

The current focus on the Eurozone has been dramatized by the goings-on in Greece. Observers may be a little perplexed and confused when a small country like Greece dominates the media as it has this week. After all, Greece is a country of just 11 million people, with an economy representing about 0.4 per cent of the world economy. So what is all the fuss about? Partly it is a concern about falling dominos – if Greece falls, who will be next – Spain, Italy, Portugal? Could the Euro crisis escalate to bring to an end the Eurozone? It is also a matter of fragile and unstable global financial markets that are now so closely interwoven and integrated. One negative signal can lead to herding behaviour that spreads contagion throughout the financial world. On September 15, 2008, when just one company (Lehman Brothers) filed for bankruptcy, it lead to financial chaos and ushered in the global financial crisis. It is also about the appropriate macroeconomic policy to use in a heavily indebted country: is austerity and belt-tightening the way to go to reduce one's debt or should we try to stimulate the economy (even at the expense of accumulating more debt) so that it expands and generates more jobs and the income to pay the debt off? These are some of the issues we explore in this section.

A focus on current dilemmas, however, obscures more deep-seated structural problems associated with a monetary union. The European System of Central Banks consists of a central bank in Frankfurt and 19 national central banks located in each member country. National central banks cannot print Euros and individual member countries cannot improve competitiveness by depreciating the common currency. The monetary union is a very tight straitjacket. Was it a fateful error for these European countries to move to a common currency? In 2001 when Greece entered the European Monetary Union it could now borrow long term funds at roughly the same rate as the Germans. The adoption of Euro allowed some countries like Greece to borrow and consume more than they otherwise would and they became heavily indebted to banks elsewhere in Europe. The end result was that their exports were dearer, wages higher and budget and current account deficits larger, than that consistent with responsible economic management. Some statistical manipulation of the official economic data hid the extent of the problems even before the global financial crisis occurred. Deficit figures were understated by moving expenses off the books so that a reported budget deficit of less than three percent of GDP actually corresponded to a real deficit of around 15 percent. Similar manipulation took place with respect to the reported inflation rate.

Martin Feldstein (2011) argues that the problem of sovereign debt crises twelve years after creation of EMU was mainly a result of imposing a strait jacket on a group of heterogeneous countries; heterogeneity that includes "economic structure, fiscal tradition and social attitudes". Feldstein believes that the European Central Bank implemented monetary policy such that the common rate of interest for the member states remained low. This low rate was too low for countries such as Greece, Portugal, Ireland and Italy that were accustomed to higher rates of inflation. Consequently, governments and private sectors in these countries heavily borrowed to finance their respective expenditure. Originally interest rates in southern Europe were higher due to concerns about devaluations and defaults but when they adopted the Euro interest rates fell and this led to massive borrowing and housing bubbles, unit labour costs rose and manufacturing became uncompetitive and trade deficits increased. The eventual collapse of the bubble led to high budget deficits, with the bank bailouts, and sovereign debt problems. The sovereign debts were mainly kept by the European banks. The slow rate of growth in these countries, caused by a strong exchange rate and inability to exercise an easy monetary policy, prevented the governments of these countries to reduce their budget deficits.

Policy in a Straitjacket

A country can normally respond to a decline in demand and stimulate economic activity by conducting an expansionary monetary policy. However, the European Central Bank must conduct monetary policy with respect to the economic condition of the union rather than an individual country, implying that interest rates may be too high for come counties and too low for other countries. In terms of debt, it matters if you borrow in your own currency or someone else's. Spain, Greece and Ireland's debt is in euros. If you borrow in your own currency, the central bank can always buy federal debt, and you can devalue your currency. Cases of successful austerity typically involve large currency devaluations that make their exports more competitive. But Greece, without its own currency, didn't have that option. If you can't control your currency and devalue, then you have to reduce costs internally and wage cuts will be resisted. Individual countries have their own budgets and labour markets but not their own currencies and so may be condemned to stagnation and civil unrest when asked to use austerity programs to deal with their problems. Being a member of the Eurozone trapped Greece in an economic straitjacket. It can rightly be said that the Greeks are in many ways the authors of their own tragedy. But the austerity program imposed on them in order to receive bail-out money has seen their economy shrink by a quarter, unemployment rise to 25 per cent and youth unemployment to 50 per cent. The Greek government was spending excessively in the late 2000s but since that time has significantly reduced spending and raised taxes. Government employment has fallen more than 25 percent, and pensions (which were too generous) have been cut sharply. Paul Krugman says that if you add up all the austerity measures, they have been more than enough to eliminate the original deficit and turn it into a large surplus. So why didn't this happen? Because the Greek economy collapsed, largely as a result of those very austerity measures, dragging revenues down with it. He goes on to say: "The truth is that Europe's self-styled technocrats are like medieval doctors who insisted on bleeding their patients — and when their treatment made the patients sicker, demanded even more bleeding. A "yes" vote in Greece [in favour of further austerity in return for a financial bailout package] would have condemned the country to years more of suffering under policies that haven't worked and in fact, given the arithmetic, can't work: austerity probably shrinks the economy faster than it reduces debt, so that all the suffering serves no purpose".

Greece has over the last five years meet most of the austerity demands but the economic situation has not improved and it appeared that they had now drawn a line in the sand and said that further austerity has to stop. That said, the current predicament was dire. In advance of the referendum, the European Central Bank cut off access to additional funds by the Greek banks, generating public panic and forcing banks to limit withdrawals or close completely. The government also imposed capital controls to restrict currency flight. If the European Central Bank did not resume normal financing it would precipitate the introduction of a parallel currency which might have turned into the new drachma. Greek banks were understood to have only a few days of cash available and less than 0.5% of the €120 billion deposits that Greek citizens have deposited. Greece might well have defaulted on its €341bn ($500bn) government debt. The government had a $3.5 billion repayment due to the ECB in mid-July. Interest rates on Greek government bonds had risen to 16 per cent as markets prepared for the possibility of default. Normally in this situation a nation's central bank simply prints more currency. Greece can't do that as it does not control the circulation of Euro currency. It might have ultimately had to print its own currency again. There may be a massive fall in the value of that new currency. Yet polls have consistently shown that the majority of Greeks want to remain in the Eurozone.

Paul Krugman states that it has been obvious for some time that the creation of the euro was a terrible mistake. Europe never had the preconditions for a successful single currency. Should these countries in deepest problems then return to independent currencies? In other words, leave the euro. A Grexit - — Greek exit from the euro - is still extremely unlikely. Legal experts tell us that there is no coherent way in which Greece can make an orderly exit. There is no legal mechanism with which to do so. They say that financial commentators who believe in a high probability of a Grexit are either deluded, or have little comprehension of how the institutional mechanisms and procedures of the EU actually work. Even if these legal hurdles could hypothetically be cleared there are a variety of views about who should be excluded from the European Monetary Union to keep the Union viable. Some note that there are now two Europe's and we might have to divide the Eurozone into two subregions (those that have efficient economies and sensible, prudent economic management and those that do not). Or it may be that Germany is such a productive economy that it should go it alone, as its standards of monetary and fiscal discipline cannot be matched elsewhere in Europe. Another alternative is a fiscal union – a central body that set taxes and government spending – to complement the monetary union. With a monetary union, a country losses its exchange rate policy and its independent monetary policy. A fiscal union would deprive it of its fiscal policy. Few countries could agree to that loss of sovereignty.

The symmetry of business cycles is an essential condition for establishment of a successful monetary union. When business cycles of members are symmetric, changing the rate of interest or the exchange rate of the single currency will not leave some countries worse-off. The Eurozone does not have an efficient and flexible mechanism for dealing with economic shocks. Spill-over effects of one country running substantial deficits that directly affect the financial arrangements of other countries do not have an efficient corrective mechanism. The interdependence of debt holdings within the Eurozone enables countries that run large deficits to free-ride via potential subsidies from other countries with prudent fiscal policies. It is now clear that the latter out of fear of the consequences of default will tend in crisis to assist the imprudent. The European Central Bank and the European Commission do not have the means to deal quickly and effectively with the spill-over and free-rider consequences of deficit countries, or they do not have the means to prevent the underlying circumstances, that of countries running large and persistent deficits, from emerging. Any discussion of policy to increase the capacity of the Eurozone to deal with economic shocks, short of a fiscal union, has to directly address at least two issues: first, how to identify profligate (as opposed to counter-cyclical) fiscal policy by Eurozone countries; and second, how to increase credibility in Eurozone institutions, such as the European Central Bank. If these requirements cannot be met, then effective, but even more unattractive alternatives are a fiscal union or abandonment of the monetary union.

Whether these drastic long-term institutional reforms are feasible or politically desirable is questionable. Greece's current situation was and still remains dire. A compromise was reached at the last moment. But this is only a temporary reprieve. It gives Greece some breathing room that will hopefully stimulate the growth of employment and income that helps finances debt repayment. Yet that will also depend on the state of the world economy, over which Greece has no control. However, the Euro structural problems remain. The 'crisis' has just been postponed. Meanwhile the cost of the bailout package, in terms of its austerity measures that will need to be implemented, will further add to the pain of the Greek people.

7. A Possible Solution

A political union may not be feasible in the near-term. The currency union has already deprived member countries of an independent monetary policy or exchange rate policy. This loss of sovereignty would be compounded in a fiscal union where countries would be deprived of the use of an independent fiscal policy. But is there a way to preserve sovereignty over fiscal matters but still assist those countries that face asymmetric disturbances – such as those that face Greece now? Can the rest of the union assist Greece to deal with its depressed economy and intolerable unemployment rates while at the same time preserving fiscal sustainability and discipline? We think the answer lies in strengthening regional automatic stabilizers. Fiscal stabilization can result from discretionary policy-making, where governments actively decide to increase spending or lower taxes. In contrast, government revenues and expenditures will also change independent of any discretionary action – via the automatic fiscal stabilizers. Automatic fiscal stabilizers are the reaction of the budget to economic fluctuations in the absence of any government action. These result from structural features of taxation and social transfers that are built into tax codes and social legislation. They can also be built-in regionally so that revenues are released centrally when a member countries experiences unemployment or a fall in GDP over some fresh hold level. A trigger mechanism releases funds automatically once unemployment exceeds a certain rate or GDP falls by a certain percentage. If economic activity weakens, then taxation revenue will automatically decline (as the community's income falls) while government spending would increase (as more people are eligible for unemployment benefits and other welfare support). This automatic fiscal stimulus, associated with the budget moving into deficit (or the surplus falling), cushions the slowdown in economic activity. Automatic stabilizers cause the budgetary balance to move so that it acts counter-cyclically. But within a nation this may not be enough to restore stability and hence a regional mechanism should supplement these domestic automatic stabilizers.

Automatic stabilizers are judged to operate symmetrically over the cycle. It was calculated that in the euro area a one percentage point increase (or decrease) in real GDP growth improves (or worsens) the budget balance by 0.5 percentage point of GDP owing to the operation of the automatic stabilizers. (This average varies across countries depending on their tax structures, welfare programs and size of governments). These automatic stabilizers were directly linked to the structure of the economy and so can respond quickly and transparently. The ECB concluded that automatic stabilizers are all that are normally required to stabilize economies: 'Automatic stabilizers are the appropriate way to stabilize output, as they have foreseeable, timely and symmetrical effects' and 'there is normally no need to engage in additional discretionary fiscal policy-making for stabilization purposes' (ECB 2002 pp. 41, 46). These views led to the fiscal aims embodied in the Maastricht Treaty and the rationale of the Stability and Growth Pact for fiscal discipline. The fiscal directives now involved a budgetary position of balance or surplus in the medium term (over the business cycle). In any particular year the budget balances may improve or worsen in line with cyclical influences (due to the automatic stabilizers) as long as it does not exceed a 3 percent of GDP limit (except in exceptional circumstances like a fall in real GDP of at least 2 percent) under threat of sanctions. Generally, most fluctuations were to be handled by the automatic stabilizers and only very severe shocks to the economy, beyond the capacity of the automatic stabilizers to dampen, would allow the operation of the discretionary stabilizers. European Union countries have implemented clear fiscal rules. The Stability Pact of the Maastricht Treaty involves budget deficits constrained at 3 percent of GDP and gross public debt constrained at 60 percent of GDP.

Budgets are to be balanced or in surplus over the medium term. As a result, EU countries have reduced their aggregate budget deficits from 5.5% of GDP in 1993 to less than 3% in 1997 and were almost balanced in 2000. The Pact rules try to restrict overly active fiscal management and excessive deficits that cannot be justified on the basis of government investment expenditure or economic distress. However, they are based on domestic automatic stabilizers having sufficient strength and our argument is that regional automatic stabilizers need to be established in addition to the domestic ones. Empirical research generally supports the effectiveness of these automatic stabilizers. Over the 1990s the automatic fiscal stabilizers worked to dampen cyclical fluctuations by roughly a quarter on average. Another study concluded that fiscal federal stabilizers offset 20-30 percent of any initial reduction in income. Eichengreen (1996) calculates that automatic stabilizers offset about 36 percent of a fall in output generated by a negative shock. In Finland and Denmark without the automatic stabilizers output volatility in the 1990s would have been twice as high (Cohen & Follette 2000). However, in current times this has not been enough to rely on the domestic responses. They need to be supplemented. New stabilizers for demand shocks need to be explored – like a regional tax on layoffs or investment tax credits.

A constraint on the operation of automatic stabilizers is the implementation of rigid fiscal rules. The debate on fiscal policy in Europe has centred on how to facilitate the workings of automatic stabilizers while achieving fiscal consolidation. Does budget balance refer to the actual budget or the cyclically-adjusted structural budget balance and is the 3 percent of GDP budget limit too severe? If the actual budget is to be balanced then the automatic stabilizers are negated. Note also that fiscally responsible Scandinavian countries have run deficits as high as 8 percent of GDP. Noord (2000) finds that automatic fiscal stabilizers have generally reduced OECD cyclical volatility in the 1990s but in some countries the need to undertake fiscal consolidation has forced governments to take discretionary actions that have reduced if not offset the beneficial effects of the automatic stabilizers. He finds in the 1990s that discretionary fiscal policy acted as a powerful complement to automatic fiscal stabilization in OECD but in the European Union the tight stance of discretionary fiscal policy contributed to the sluggish economic performance.

The Stability Pact with its adherence to the Maastricht restrictions has been strongly criticized for not leaving enough scope for the operation of the automatic stabilizers. Governments trying to bring down public deficits and public debt to comply with the convergence requirements have generated contractionary effects on the economy and subsequently output and income growth in Europe has fallen. The European Union experience leads to a broader policy concern. With the creation of a single currency and the disappearance of national monetary policies, the debate has focused on the need for fiscal federation. In Europe, monetary unification increases the need for national automatic fiscal stabilizers. National monetary policies are no longer available to cushion shocks. The exchange rate has already been lost as an independent policy instrument. There is a European Central Bank for monetary policy. Should we establish a central EU authority for fiscal policy? Would fiscal stabilization at an EU-wide level be more effective than devolved to nations? The debate in Europe is about the lack of fiscal stabilization at the EU level, in contrast to the existence of important fiscal stabilizers at the federal level in other monetary unions.

Supporters argue that Europe needs a fiscal federation or at least closer fiscal coordination. With the loss of monetary policy independence, and with fiscal policy constrained by rules, this leaves economies very vulnerable to instability. As prices and wages are not highly flexible, and there is only limited labour mobility, there is the risk of deep recessions and widespread unemployment. A Sustainability Council for the euro area could be established with national governments submitting their fiscal plans to this Council. The Council might develop some sort of an insurance mechanism to channel income from countries enjoying a positive shock to countries suffering a negative shock -based on growth differentials relative to the EMU average growth rate or by using unemployment based mechanisms. Opponents to this idea claim that such a system would be highly regressive as the faster growing countries are also poorer and that it is not wise to reward a country's poor unemployment record. Eichengreen (1996) argues that a fiscal federation is politically and administratively too hard to achieve and we should just let the automatic stabilizers operate. But they need to be strengthened and regionally-operative.

Regional automatic stabilizers, that release funds to all member countries once certain targets are missed in terms of GDP growth rates and unemployment rates, allows the automatic stabilizers free rein as they are judged to be more flexible and work more quickly than the discretionary ones. The automatic stabilizers represent a predictable and systematic response, setting out rule-like mechanisms for changes in spending and taxes. There is room to strengthen old automatic stabilizers and to develop new ones. Perhaps consumption taxes are efficient stabilizers. For expenditure programs we need temporary stimulus that disappears once the economy has returned to normal such as Federal grants to States based on the amount of excess unemployment. Devising mechanisms yielding temporary stimulus but which would self-terminate as recovery ensued – based on unemployment trigger mechanisms – are a challenge to policy-makers.

8. Conclusion

The European monetary union has had a record of considerable success until recent times. The current problems reflect deep-seated structural problems. If not addressed, these problems may lead to the collapse of the union. In many ways that would be regrettable. Polls of the Greek people show convincingly that they do not want to exit. What we have proposed here is a mechanism that might go some way to strengthening the economic foundations of the union.

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Figure 1: Inflation Differentials of EMS Members

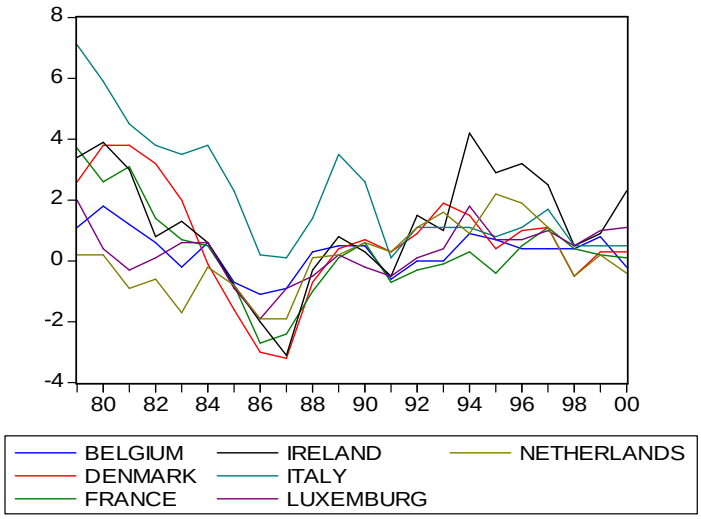
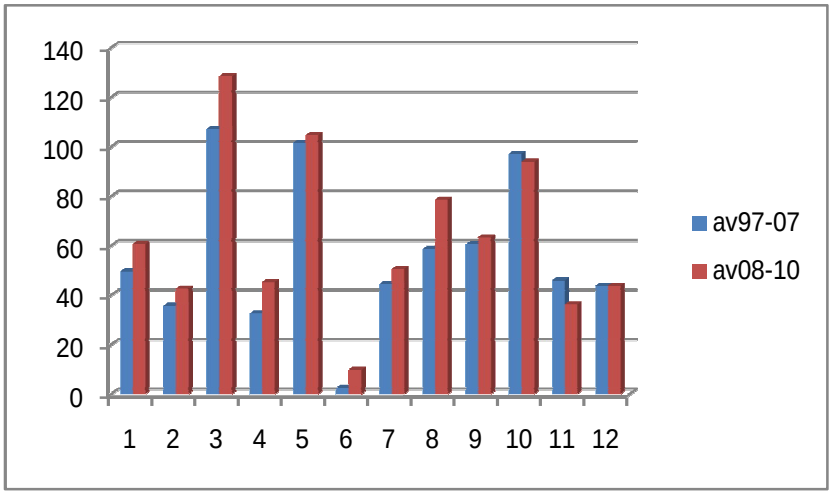


Table 1: Economic Indicators of Maastricht Treaty Convergence Criterion March 1998

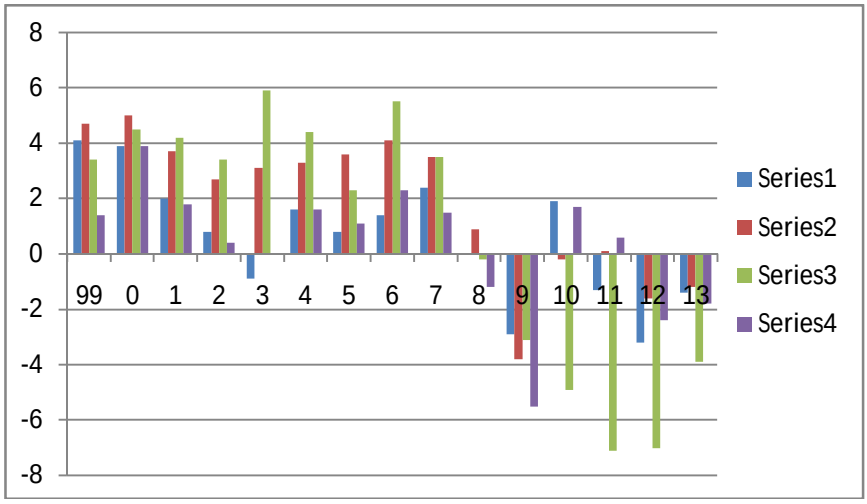
Country	Inflation %	Budget Deficit % of GDP	Public Debt % of GDP	Long Term Interest Rate %
Austria	1.1	2.3	64.7	5.6
Belgium	1.4	1.7	118.1	5.7
Denmark	1.9	-1.1	59.5	6.2
Finland	1.3	-0.3	53.6	5.9
France	1.2	2.9	58.1	5.5
Germany	1.4	2.5	61.2	5.6
Greece	5.2	2.2	107.7	9.8
Ireland	1.2	-1.1	59.5	6.2
Italy	1.8	2.5	118.1	6.7
Luxemburg	1.4	-1.0	7.1	5.6
Netherlands	1.8	1.6	70.0	5.5
Portugal	1.8	2.2	60.0	6.2
Spain	1.8	2.2	67.4	6.3
Sweden	1.9	0.5	74.1	6.5
United Kingdom	1.8	0.6	52.3	7.0
Convergence Criterion	2.7	3.0	60.0	7.8

Figure 2: Average Government Debt Ratios in 12 EMU members



On the x axis numbers 1 to 12 refer to France, Germany, Greece, Ireland, Italy, Luxemburg, Netherlands, Portugal, Austria. Belgium, Finland and Spain respectively. This graph is reproduced from Monadjemi and Lodewijks [2014].

Figure 3: Growth Rates of 4 EMU Members



In Figure 4 Series1, 2, 3 and 4 are Portugal, Spain, Greece and Italy respectively. On the horizontal axis 0 to 13 refers to 2000 to 2013. The source of data is OECD main economic indicators.