

Francesco Franco

Internal and External rebalancing for Euro area members

INTRODUCTION

Factual evidence since the start of the global financial crisis in 2008 shows that the Euro area members face strong challenges to attain simultaneously internal (employment and output) and external (balance of payments) balance. The lack of policy or market mechanisms designed to attain both balances is a weakness in the architecture of the currency area that has been identified since the 1960's but that are still waiting for a viable solution. The southern Euro-members, given their common internal and external positions, should push for comprehensive and rational mechanisms that can help the achievement of the dual rebalancing.

In this brief talk, my aim is to elaborate an argument for a stabilization fund financed by a flexible mix of VAT and payroll revenues that can perform the role of an adjustment mechanism.

The first part of my presentation presents a narrative of the necessary and sufficient conditions that have been identified for a functioning currency area. This first part highlights some of the conditions identified in the economic literature and how they depend on the hypotheses presented in each specific study. The key message of the first part is that the above hypotheses do not always reflect empirical regularities but that sometimes they reflect beliefs. The idea that the market-based mechanism of internal devaluation, basically a decrease in nominal wages due to an increase in unemployment, would be a sufficiently rapid adjusting mechanism within the Eurozone has been proven wrong, at least in its "rapid" qualification.

The second part of my presentation presents two episodes relating to currency realignment, i.e. the mechanism that existed in the smaller European Union during the European Exchange Rate Mechanism (ERM). These episodes show that imbalances were difficult to resolve even when EU members maintained their own currency. Finally, the third part presents a proposal to explore an adjustment mechanism for the euro area members.

The mechanism is not new as far as it builds on the several existing proposals for a Common European Unemployment Insurance and are also present in the case of the less ambitious European stabilization fund. The novelty of the proposals consists in the financing of the fund with a flexible mix of VAT and payroll taxes. This financing scheme builds on the results that neutral budget tax swaps between VAT and payroll taxes can mimic the effects of currency realignment. The mix should be adapted to the relative position of each euro member in order to allow him to perform a fiscal devaluation or a fiscal revaluation, i.e. a fiscal realignment, while letting the stabilization fund help to achieve the internal balance objective.

THE NECESSARY AND SUFFICIENT CONDITIONS FOR A FUNCTIONING CURRENCY AREA

Relative prices adjustment

It is patently obvious that periodic balance-of-payments crises will remain an integral feature on the international economic system as long as fixed exchange rates and rigid wage price levels prevent the terms of trade from fulfilling a natural role in the adjustment process.

Robert Mundell

Two countries that trade in goods and assets need a mechanism that allows relative prices and wages to change for them to be able to achieve both internal and external balance. While there is little or no disagreement on this necessary condition, there are different opinions as to the effectiveness of the mechanisms to achieve changes in relative prices and wages. As an example, assume that the Italy has trade deficit with Germany. To regain competitiveness and recover the external balance the hourly wage in Italy must decrease relative to the hourly wage in Germany. In the presence of national currencies, the nominal exchange rate is the price that permits to the relative prices to change instantaneously: the nominal value of the Italian currency decrease relative to the German currency which implies that the nominal hourly wage in Italy decreases relative to the German hourly wage.

When there is no exchange rate one needs an alternative mechanism. Some view market mechanisms as sufficiently rapid and strong to achieve adjustments through wages and prices changes. For example, a former

member of the ECB board in explaining the “Economic adjustment in a monetary union” (2011) writes:

“...Therefore, the key adjustment mechanism in a monetary union is price and wage flexibility, assuming that cross-border labor mobility is limited...(…)... In fact, wages and prices are, by definition, the only remaining component of the real exchange rate that can be adjusted in the absence of nominal exchange rate flexibility.” The problem with this view is that the facts point to a strong downward nominal wage rigidity (see for example the evidence reported by the Wage Dynamics Network of the ECB and national central banks) with the implication that the adjustment results in higher unemployment and lower consumption. The lower consumption reduces imports and that helps reaching external balance but at the cost of larger internal imbalance.

Mundell (1961) in his classic paper identified labor mobility as an alternative mechanism to wage and price adjustment. In short, emigration from the country that need to restore internal balance would help to achieve full employment by shrinking the labor force. Farhi and Werning (2014) shows that Mundell’s mechanism is not so straightforward because emigrants are not just workers but also consumers: emigration reduces the labor supply but also the demand of goods. They show that the net effect of emigration is positive if the degree of openness and trade integration is high, a metric that was identified by McKinnon (1963) as another condition for two countries to share the same currency. Furthermore, emigrants are also taxpayers, human capital, etc. etc. adding layers of complexities to the net effect of migration as an adjustment mechanism.

Fiscal integration

It is a chief function of fiscal policy, using both sides of the budget, to offset or compensate for regional differences, whether in earned income or in unemployment rates. The large-scale transfer payments built into fiscal systems are interregional, not just interpersonal [...]

Peter Kenen

A second condition made popular by Kenen (1969) is the level of fiscal integration between countries that share the same currency. The key point is that an integrated fiscal policy implies the existence of automatic stabilizers

such as a common unemployment insurance that transfer resources from countries that are in a boom, and therefore have low unemployment, to countries that are in a recession and therefore have high unemployment. Integrated fiscal mechanisms therefore help to achieve internal balance.

There exists a disagreement on the desirability of this condition. For example there is a view that fiscal transfers might help to achieve the internal balance but in an artificial way as they do not permit the adjustment in relative prices to occur. The statement of a former member of the board of the ECB (2011) summarizes this view: "Open-ended transfers, however, are not a mode of adjustment. In fact, they are the opposite. They finance non-adjustment."

Financial integration and others conditions

Today, the focus of the reforms that the euro area architecture must adopt is more on financial integration. For example, Eichengreen and Wyplosz (2016) identify the completion of Europe 's banking union as one of four minimal conditions for the euro area to continue to exist in the near future. With a full banking union, financial markets can achieve a better and more efficient allocation of resources and provide a smoother financing of the external imbalances between countries. Other reforms are put forward, such as improving the capital markets integration across Eurozone members to achieve a better risk sharing or the necessity for the European Central Bank to have in his mandate the role of lender of last resort in order to backstop financial markets in government bonds, thereby protecting the euro area from potentially self-fulfilling crises (De Grauwe 2011).

In fact if all the conditions required for a functioning currency area are listed (see for example Stiglitz (2016)), one can easily conclude that the common currency might not be the best monetary arrangements for European countries. **I do not subscribe to this view.** Trade and financial openness have long implied misalignments between different fiscal and monetary jurisdictions as shown by the different monetary and trade arrangements that have existed in the past.

This takes me to the second part of this talk where I refer to two episodes of currency realignment during the ERM with the aim of reminding us that difficulties in the adjustments were not particularly less intense when countries had their own currencies.

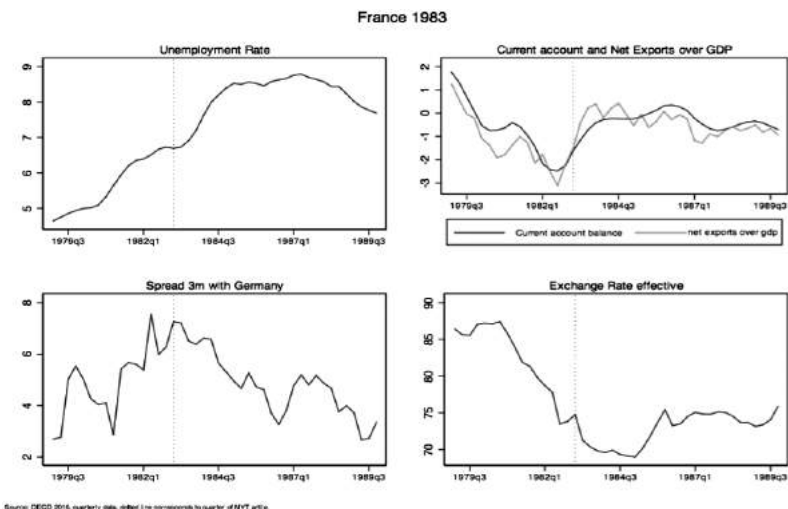
REALIGNMENTS DURING THE ERM

France 1983

Eight European nations agreed today to realign their currencies after West Germany accepted French demands and agreed to a set of currency values that avoided the possible collapse of the European Monetary System...()... German officials said Mr. Delors had given assurances that France would reduce its budget deficit by cutting spending on social programs and welfare payments. Mr. Delors also reportedly said that France would try to reduce the deficits of its nationalized industries, another cause of inflation. The devaluation itself would cut the trade deficit by making imports more expensive and exports less costly to others.

New York Times, 21-3-1983

In a not too distant past, realignments between European countries required everybody's agreement. This was the case for the episode reported by the NYT in the above quote. At that time, France was experiencing a process of internal devaluation (lower wages and prices through higher unemployment) that had been accompanied by three previous realignments between the Franc and the Deutsche Mark in order to face an increasing external imbalance. Ultimately France was able to restore the competitiveness and close the trade deficit but at the cost of higher unemployment notwithstanding the devaluation of the Franc.

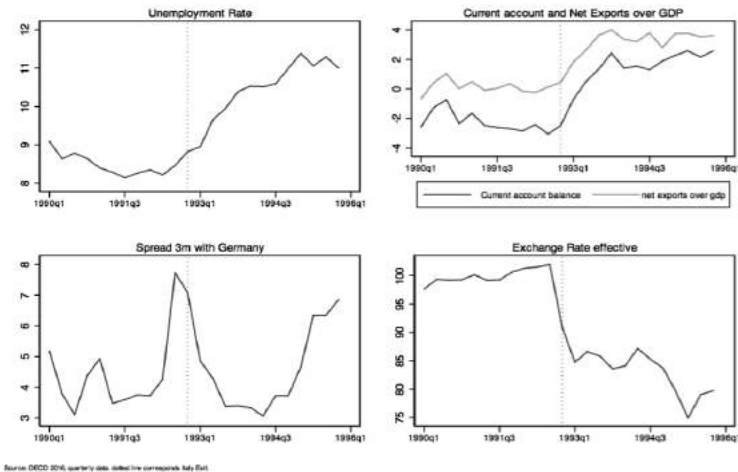


Italy 1992

In another instance, in 1992 an agreement on realignment was not reached and this caused Italy to exit the ERM. By 1992, countries had experienced different paths in unit labor costs (divergence); there had been a (very) large asymmetric shock (Germany reunification); the European political project was perceived to be weaker (French and Danish referendum); and European leaders were unable to coordinate among themselves (Bath summit). The 13 years of ERM existence before the crisis had pushed members to develop effective procedures to coordinate the setting of the exchange rate parities which, in the best European tradition, required unanimous approval. Unfortunately the “un pour tous, tous pour un” approach is meant to be self supportive for a group that stays loyal to each other through thick and thin. This is not the best description of European leaders during the ERM crisis when realignment became “a dirty word in Bath.” (see Buiter and al. 1998). In the absence of consensus, Italy and Germany had to bilaterally propose that the Lira would devalue by 3.5% and the Mark revalue by 3.5% against all currencies in the ERM. Some members refused.

The Lira was initially the only currency to be devalued (by 7%). Ultimately the Lira left the ERM and was allowed to reenter a few years later devalued by circa 25 percent. Italy was ultimately able to adjust without external help thanks to an ambitious fiscal consolidation, structural reforms and privatizations (circa 10% GDP). In that case as in many others, the forced devaluation of the Italian lira improved the trade balance. But again external balance was recovered at the cost of deterioration on the internal balance.

Italy 1992



A STABILIZATION MECHANISM

Fiscal devaluations

A basic criticism against the Euro is that devaluations and revaluations are not anymore possible across member countries. While the examples above show that national currency realignments were not a panacea, the euro area needs mechanisms to emulate the effects of devaluation and help the adjustment of external imbalances. A possibility is to use neutral tax swaps. In Franco (2011), I have looked to the effects of a “fiscal devaluation,” namely a decrease in labor taxes balanced by an increase in consumption taxes (see Farhi et al. 2014 for a more complete treatment). It is not a perfect substitute for a nominal devaluation: it has advantages, such as no adverse effect from foreign denominated debt, and has disadvantages, such as the imperfect pass-through and the legal difficulties to implement it compared to a currency devaluation. Nevertheless, it is a fiscal mechanism that aims at reducing external imbalances across the currency area countries by allowing relative prices to change.

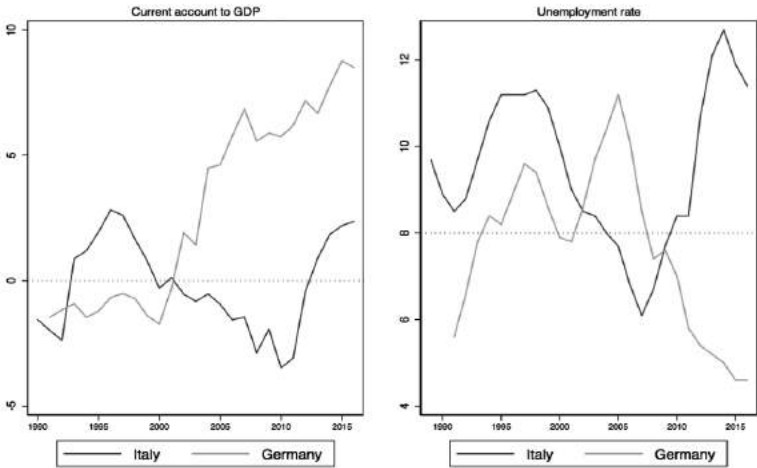
Unemployment insurance

A mechanism that has been suggested (see Claeys et al. 2014) and which is the subject of active current research is the increase of fiscal integration of the EU to allow for implicit or explicit temporary fiscal transfers across members. Popular variants are a common European unemployment insurance to complement national systems or a simpler stabilisation fund. This fiscal mechanism aims at helping countries to achieve the internal balance across the currency area countries. The advantages of such mechanism are many. For example the automatic stabilisers would work with a smaller impact on the country fiscal deficit and therefore should decrease the probability that the discretionary part of fiscal policy would become pro-cyclical during a downturn given that total deficits are constrained by European rules. There are also disadvantages. For example fiscal transfers could slow down the adjustment of relative prices and impair the adjustment of external imbalances. There are also concerns of a microeconomic nature such as moral hazard issues in designing national unemployment benefits legislation.

Nesting Unemployment insurance with Fiscal Devaluations

I suggest we consider the nesting of an unemployment insurance (UI) mechanism financed through a flexible fiscal policy mix that can mimic

realignments through fiscal devaluations (FD). The unemployment insurance can be a simple insurance mechanism or a more complex European UI and plays the role of an automatic stabiliser for the internal balance. The financing would be done through a mix of VAT and Payroll taxes. The financing mix should change symmetrically across surplus and deficit countries to help the external balance adjustment and permit relative prices to change in the right direction. I underline the symmetry in the change in the mix not to let the burden of changing on the deficit country alone. The key condition, namely the existence of time varying asymmetry in external and internal position across the euro area countries, is thus fulfilled.



Source: Ameco 2016. Example: The external balance is set at CA/Y=0 and internal balance is at Urate=8.

There are a number of issues that must be addressed in setting up such a mechanism. In particular it has to respect existing treaties and demonstrate that it can produce a win-win setup for the common currency. This is not the place to enter in details but I plan to look carefully at those in the immediate future.

CONCLUSIONS

I focused on macroeconomic adjustments within the euro area and not on possible long run trend differences in competitiveness that require microeconomic and structural policies. The latter are of course important

but so are the imbalances. Furthermore there is increasing evidence that macroeconomic imbalances might have consequences that are extremely persistent if not permanent (Blanchard and Summers 2015). My main point is that the euro area needs policy instruments that permit internal and external rebalancing and that are coherent with the degree of national sovereignty. The recent experience has shown that internal devaluation is not a sufficient mechanism to this end. In this talk, I build on existing studies and suggest that **euro member states could initially agree on a relatively small stabilisation fund to be financed through a flexible mix of VAT and Payroll taxes**. The payments from the fund to member countries would be done according to the internal balance and the member countries tax-mix that finances the fund would change symmetrically according to the external position. The mechanism could be tested and scaled up later if successful. Ultimately, we need to agree that these imbalances matter.

REFERENCES

- Claeys, Gregory, Zsolt Darwas and Guntram B. Wolff. Benefits and Drawbacks of European Insurance. Bruegel Policy Paper 2014/06.
- Blanchard, Olivier, Cerutti, Eugenio and Summers, Lawrence. Inflation and Activity – Two Explorations and their Monetary Policy Implications. NBER No. 21726 2015.
- Buiter W., Giancarlo M. Corsetti and Paolo A. Pesenti, 1998. Interpreting the *ERM Crisis*: Country-Specific and Systemic Issues," Princeton Studies in International Finance No. 84.
- De Grauwe, P (2011), "The Governance of a Fragile Eurozone", Economic Policy, CEPS Working Documents.
- Farhi, Emmanuel, Gita Gopinath, and Oleg Itskhoki. 2013. "Fiscal Devaluations." Review of Economic Studies 81 (2): 725-760.
- Farhi, Emmanuel, and Ivan Werning. 2014. "Fiscal Unions", mimeo Harvard.
- Farhi, Emmanuel, and Ivan Werning. 2014. "Labor Mobility Within Currency Unions". mimeo Harvard.
- Franco, Francesco. External rebalancing in the EMU, the case of Portugal. 2011, mimeo Nova SBE.
- Kenen, Peter, "The Theory of Optimum Currency Areas: An Eclectic View," in R.A.

Mundell and A.K. Swoboda, eds., *Monetary Problems of the International Economy*, Chicago University Press, 1969.

Keynes, J.M., "The German transfer problem," *The Economic Journal*, 1929, 39 (153), 1–7.

McKinnon, Ronald, "Optimum Currency Areas," *American Economic Review*, 1963, 53, 717–724.

Mundell, Robert, "A Theory of Optimum Currency Areas," *American Economic Review*, September 1961, 51 (4), 657–665.

Mundell, Robert, "The Economics of Common Currencies," in H.G. Johnson and A.K. Swoboda, eds., *Uncommon Arguments for Common Currencies*, Allen and Unwin, 1973.

Krugman, Paul (2013) 'Revenge of the Optimum Currency Area', in Daron Acemoglu, Jonathan Parker, and Michael Woodford (eds) *NBER Macroeconomics Annual 2012*, University of Chicago Press.

Stark, Jurgen (2011). 'Economic adjustment in a monetary union'. Speech by Mr. Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Bank of Latvia annual conference "Global Challenges and Local Opportunities: Achievements and Prospects in the Baltic States", Riga, 12 October 2011.

Stiglitz, Joseph (2016) *The Euro: How a Common Currency Threatens the Future of Europe*. W.W. Norton.