JUDIT PAPP *

Single Currency – at what price?

1. INTRODUCTION

The European Economic and Monetary Union is approaching its first birthday in a few weeks: the establishment of the new currency zone was surrounded with a great deal of controversy and its short life has been filled with excitement. January 1, 1999 the euro was introduced with high expectations, ceremony, joy, and an assigned value of 1.685 USD per EUR. Then, it suddenly became slippery and the euro could hardly stop sliding at USD 1.014 before reaching parity with the dollar. Long-lasting American boom, set-back growth in Europe, economic and financial downs in Asia and Latin-America, changes in political leadership of the EMU-11, or overshoot propaganda were all to be blamed. But life goes on and with cheaper exports, strengthening business confidence, increase in consumer spending, all this backed up with a 0.5% cut in interest rates, the euro started a slow and fragile recovery. Educated guesses try to forecast the future life of the artificial currency, politicians and economists engage in hot debates about the recent, most far-reaching step in the history of European integration.

Arguments for monetary integration in Europe call for the need of a united entity that is able to face challenges of a globalized world economy,

---

* Student of the Colleges of Management and Business Studies. Shortened version of her dissertation. Supervisors: Prof. P. Majoros, and Prof. L. Kacsirek.

that can compete with the economies of North America and the Asian region, and which manages to overcome barriers to sustainable growth of European economies by eliminating the obstacles from the creation of a true Single European Market. The introduction of the single currency enables the euro-zone to save about 0.4% of Community-wide GDP through the loss of transaction costs, a further 0.5% increase in GDP is expected resulting from the removal of exchange rate uncertainty, which in turn rationalizes decision on corporate location leading thus to increased efficiency in production. Elimination of cost and price discrimination enhances competition, the single Central Bank will manage monetary policy with a considerably smaller amount of reserves than the need of its predecessors used to be and the strong voice EMU is expected to obtain in the world economy is also a tempting aim to give up national currencies and monetary policies for.

On the other hand there are serious arguments warning against the potential threats present in the establishment of a single European currency-zone. It is worth following through dangers and possible costs of the single currency and consider whether expected gains can compensate for losses inherent in the idea of an economic and monetary union in Europe.

2. THREATS TO THE SINGLE CURRECY AREA

There are several opponents even to a fixed exchange rate mechanism as a tool to regulate a nation's economy. According to a study by the Western Washington University, ten years ago only eight of the world's major currencies operated under fully flexible exchange rate regimes, fourteen countries employed managed regimes, and sixty-four maintained fixed exchange rates. Today thirty-three countries use flexible rates, eighteen have managed systems, and only forty work under fixed regimes.[1]

Having overcome dispreference towards fixed regimes, however the EU made a step even further to deepen its internal market by introducing a monetary union. The above short overview derived the benefits of an economic and monetary union in Europe from the introduction of a single currency. The main source of costs can also be found by analyzing this same fact. Dangers of EMU lie in the loss of national monetary policy: the possibility to use the exchange rate as a short-term adjustment tool, and the ability to set interest rates or „manipulate" inflation rate according to best interests of the specific country. The euro-zone is assigned a single,

[1] Dean (1997), pp. 57-74.

one-fits-all monetary policy by the European Central Bank, various currencies are merged into the new euro. Theoretically it should mean no difficulty given that countries or regions comprising the monetary union represent similar economic structures, business cycles move in line with one another, they are exposed to similar economic disturbances or in general, these economies are well synchronized. Convergence criteria set in Maastricht also served to ensure that once EMU would start, real economies of founding members „converged". Reality, however rises serious thoughts in regard to complete harmonization: in general we can say that the monetary field does not call for concerns in itself, it is rather sustainability of the present low-inflation era that raises questions; fiscal stance of member states, however typically represents a diluted form of the originally strict set of convergence criteria.

In order to see to what extent this fact poses a threat to member states first it needs to be considered whether giving up exchange rates affects the region at all.

Economic theory states that exchange rate is an effective adjustment tool of monetary policy in the short run if:

- the areas face asymmetric shocks, which requires adjustment of relative prices;
- domestic prices are not fully flexible and thus do not react to shocks immediately;
- domestic prices are not immediately indexed to the exchange rate and changes in relative prices are thus not immediately neutralized;
- other adjustment mechanisms, such as factor movements or fiscal federalism are absent;
- adjustment by exchange rate is less costly than by other instruments[2].

If the above conditions hold, central banks may need to manipulate exchange rates to keep the economy on a normal track. The following sections are going to analyze whether monetary union in Europe is beneficial based on the above criteria and with help of the theory of optimum currency areas (OCA). The OCA theory tries to answer the question under what conditions it is beneficial (resulting in more gains than losses) to introduce a common currency among countries or regions.

ROBERT MUNDELL, a father of the theory[3], stated two conditions for an optimum currency area: the first one is that the regions comprising the common-currency area should be subject to common economic changes with common effects; the second one states that labour must be mobile between regions. Is one of the conditions absent, the region is subject to *asymmetric shocks*. The term refers to economic disturbances hitting

[2] Ricci (1997)

[3] Mundell was awarded the Nobel-prize of Economic Sciences for his work on OCA-theory in 1999.

either only part of a region/country or exerting different impacts on the various parts of the region/country. To follow it through an example, suppose a shift from the demand for goods of country „A” to the goods of country „B”. Country „A” faces falling output and employment, whereas country „B” has to cope with inflationary pressures. Change in the terms of trade through the change in the exchange rates of the two countries helps country „A” regain its position in the market. Consider this example in a situation where countries „A” and „B” are regions of a monetary union and share a single currency. Falling output and employment in country „A” calls for an increase in the money supply, which in turn exacerbates inflationary pressure in country „B”. It depends on the judgement of the single central bank to what extent it allows inflation to rise in the surplus country in order to relieve unemployment in the deficit country. Burden can at best be shared by allowing a specific degree of unemployment parallel with a certain rate of inflation in countries „A” and „B” respectively.

The above example introduced asymmetric shocks through the example of an asymmetric demand shock. While demand in country „B” increases, it results in decreased demand and thus a fallen output (supply) in country „A”, which in turn increases unemployment and in the worst case, it starts a downward spiral in the economy. This is usually the time when the government/central bank decides to devalue the national currency to „regain competitiveness” at least in the short run even at inflationary costs.

If we want to see possible *reasons* behind such a scenario, we may turn to international trade theory for a moment. The classical HECKSCHER-OHLIN two-factor (labour, capital), two-product model assuming full employment of factors, perfect competition, standard technology and free movement of (only) goods[4] does not explain such nationally differentiated shocks. However, instead of approaching the problem from the supply side, LINDNER[5] gave priority to factors determining demand, which became the basis to the intra-industry trade model. According to this view countries at a higher development level, whose production structure, internal demand, and economic development are similar (conditions for EMU member states), trade intensively with one another. Trade between these countries is thus based on *variety*, meaning that imported goods only differ in certain qualitative features. This in turn brings us closer to shifts in tastes leading to demand deficits in certain countries, resulting in *country-specific* shocks. A scenario of this kind is a typical example for the need of exchange rate adjustment in order to avoid deflationary spiral and unemployment.

On the other hand – as already mentioned – a major benefit of EMU will lie in the elimination of exchange rate risk resulting in greater

[4] Török (1995), p. 30.

[5] Török (1995), p. 30.

efficiency choosing corporate locations, which means potential concentration of industries in specific geographical regions that may not follow national borders. For instance, instead of a French and a German industrial region one will see the industry of the Ruhr-region. In that case, however disparities reach across national borders and the zone faces a *regionally differentiated shock*.

Countries with different levels of development are subject to country-specific shocks within the common currency area. With the deepening of the integration specialization increases, which in turn can result in region-specific shocks. If labour is not mobile between countries or regions, economic policy is needed to compensate for it and help the adjustment. If the monetary union faces a symmetric shock, the common monetary policy can be used to try and correct failures. As already mentioned, member states do not enter the union with common background in economic policy and thus the same measures may not result in the same outcome, symmetric shocks are still „easier" to cope with in comparison with asymmetric shocks. (In the case of the EMU asymmetric shocks are expected to be rather region- than country-specific.) Using the common monetary policy will not be a solution as the economic hardships are present only in certain region(s) and would thus hurt the interests of other parts of the union.

Now that possible sources of shocks as well as their nature are identified let us follow through possible solutions to the problem.

3. SOLUTIONS TO ASYMMETRIC SHOCKS

The first and most obvious idea would certainly be the *devaluation* of national currency(ies). This step would increase demand towards the country's products abroad and would help bring the economy(ies) to a healthy equilibrium. An economic and monetary union, however does not make devaluation within a country or region possible as countries or regions do not possess separate currencies with monetary policies and healthy or even booming regions would certainly not contribute to a common devaluation.

Fiscal policy is left for governments to intervene. *Expansionary fiscal policy*, however leads to an increased government debt that has to be financed in the following period, which in turn requires a tighter fiscal policy again. Is that not the case, continuos financing problems may lead to interest rates on debt exceeding the rate of growth in the economy, easily turning into a „debt-spiral". So, national fiscal policy is rather a

short-term and one-time measure for corrective action – if available at all. Having examined fiscal stance of member states, they do not have much space left before expansionary fiscal policy brings about an excessive deficit procedure defined by the Stability and Growth Pact. Thus the only long-run solution left for governments of participating member states is very carefully designed countercyclical budgets.

The previous section differentiated between nationally and regionally differentiated shocks. If the asymmetric shock hits a certain region instead of a specific member state a *common budget* would provide cure in the absence of regional monetary policy. Centralizing not only monetary but also fiscal policy can thus be of major importance when facing such disturbances. It may not only finance long-term regional development but may also lend short-term help in order to avoid real shocks.

The United States shows an example for a well-functioning system in this regard: booming states are able to pay a higher amount of tax into the budget and need less resources (e.g. unemployment benefit) to be given back; at the same time depressed states/regions pay less and need more back. Thus the Federal Budget simply redistributes funds from booming states to depressed ones. Fatás (1997)[6] presents findings of various studies on the importance of automatic transfers in a monetary union. The majority of these studies use data on U.S. states and they investigate the change in a region's taxes and transfers if income in that region decreases by 1% relative to the national average.

SACHS and SALA-I-MARTIN (1992) found that „the fraction of the initial shock that is absorbed by the federal budget is between one third and one half" or „a one dollar reduction in state personal income reduces final disposable income by only 56 to 65 cents". BAYOUMI and MASSON (1996) came to similar findings by concluding that the stabilization effect of the U.S. federal system is around 30%. Until SACHS and SALA-I-MARTIN or BAYOUMI and MASSON find that volatility of U.S. disposable income is considerably reduced by the federal budget, VON HAGEN reached results suggesting much smaller stabilization effect of U.S. federal budget than the previous investigators. His estimates state that it is only 10% of a one-dollar reduction that is absorbed by the Budget. His estimates, however still far exceed the results of SACHS and SALA-I-MARTIN on the European Union, which conclude that „if a European region or country suffers a one dollar adverse shock, its tax payments to the European Community will be reduced by half a cent. This contrasts with the 34 cents we found for the United States."

[6] Fatás (1997).

4. CONCLUSIONS

Summarizing the above statements we can conclude that there are two basic ways to counterbalance asymmetric disturbances through fiscal measures. Related to time governments can prepare countercyclical budgets and related to space redistribution through the federal budget is provided.

The *first* solution is limited by the member states' fiscal stance meaning that euro-zone governments breached the ceiling of allowed budget deficits constantly, almost every year for more than a decade and it was only the time of preparation for the 1997 weighing procedure when figures were more or less reduced. Studies in the OECD's Economic Outlook find that to cope with past downturns an increase in the budget deficit of 2% has been needed just to accommodate the automatic stabilizer function.[7] Would member states want to prepare for disturbances, governments should keep a permanently balanced budget or even a budget surplus to be able to cope with downturns without being exposed to excessive deficit procedures.

At this point it is time to examine the *Stability and Growth Pact* in a bit more detail. It defines special circumstances under which member states breaching the deficit ceiling are exempt from the procedure: deficits are allowed to exceed 3% of the GDP if the breach is exceptional, temporary, and the deficit remains close to the reference value. *Exceptionality* means causes outside the control of the member state and results of a severe economic downturn of at least 2% fall in GDP annually or at least 0.75% fall in annual GDP if losses in output and exceptionality are proven. *Temporariness* involves exemption only for the period of exceptionally negative economic circumstances, whereas the *closeness* criterion refers to the expectation to stay close to the 3% reference value.

In order to see what that potentially means to EMU member states in the future the Magazine „New Political Economy"[8] investigated how many times economic downturn in the EU fulfilled the exemption criteria. Results show that periods with negative annual real GDP growth rates of 0.75% or more did not occur frequently: thirty times between 1961-96 that is an average of two cases per country or a frequency of less than 6%. Most of these cases were concentrated around the three major recession periods: the mid 1970s, the early 1980s and the early 1990s. A fall in annual real GDP of 2% or more happened in seven cases within 36 years. This implies that two-thirds of the recessions would have resulted in excessive deficit

---

[7] The euro's first test.

[8] Postwar lessons…

procedures in the past three and a half decades in the EU. Founding members of EMU thus have to closely monitor their budgets as long as deficit figures exceed 1-1.5% of GDP.

The *second* possible solution to even out fluctuations within a common currency area was identified through the federal budget, which – proven by the cited studies – seems to be well working in the United States. *The EMU has, however no supranational budget to finance such procedures.* The budget of the European Union collects 1.27% of Community GDP in contrast to national budgets that comprise on average 50% of national GDP. Approximately one third of this 1.27% is spent on Structural Funds[9], which aim at reducing regional differences within the Union, but above that there is no source intended to smooth fluctuations in the region. Having witnessed hot debates around the latest „reform" of the Community-budget it is not easy to believe that member states will be willing to agree on a larger budget. It would also be difficult to imagine one member state to contribute more to the common budget just to help another member state in need – without any political problem.

We can conclude that fiscal policy of EMU in its current state is not an effective measure to fight nationally or regionally differentiated disturbances.

Fiscal policy not being the ideal solution the possibility to *make labour markets more mobile and flexible* is left for us to turn to. Migration of labour from depressed regions to booming ones (especially when accompanied by capital) is a most important way to avoid demand shocks. Labour moving to booming regions not only reduces excess labour supply and the need for unemployment benefits but also contributes to even out excess demand for labour in the booming regions.

Achieving this in Europe is however, a difficult task to do. Nations comprising the European Monetary Union have such differences in their cultures and traditions that makes labour mobility be very low between countries. Only the fact that nine different languages are spoken within the EMU-region represents a great barrier, which is then accompanied by complex and rather rigid welfare systems. (The problem of pension funds will also be a very difficult one to cope with, especially in the cases of Germany, France, Belgium, or Italy.) Free mobility of labour is also hindered by differences in education systems or the lack of real acceptance towards diplomas earned in other member states. Solving this problem is an urgent and extremely difficult one and it is clear that the EMU is far behind an already well-working common currency area, the United States, in this respect. (Labour mobility in the U.S. is about three times higher than that in the EU-15.)

[9] Palánkai (1999).

At this point we may say that the EU has taken a step further into deepening the integration before truly completing a precondition to it, the Single Market Program. Without a sufficient level of labour mobility the common currency area is subject to region or country-specific shocks to a rather high degree. The member states having different economic backgrounds the possibility of such shocks can not be neglected.

Macroeconomic background required by MUNDELL has been discussed. Finally let us take a look at trading relations of the region: although 60% of trade is made up of intra-EU trade, the four largest EMU-economies (Germany, France, Spain, Italy) trade no more than 10-12% of their GDP with each other.[10]

Based on the above we can state that Europe is not a natural optimum currency area. It is a collection of countries linked by trade and supranational institutions, showing large differences in culture, business cycles, economic policies, structural characteristics, or growth rates of the economy. It does not satisfy MUNDELL'S conditions for an optimum currency area: the region is not subject to economic changes with common effects, labour is not mobile between regions, fiscal federalism is absent. The ideal response to any nation-specific shock would be the immediate use of monetary policy: the reality however, is going to be a „one and only" currency that can not be managed for the benefit of all member states. It is hard to imagine that an area so manifold will never be hit by differential shocks. In the absence of compensatory monetary policy actions taken may lead to a more than reasonable burden on internal wage and price adjustment.

[10] Dean (1997), pp. 57-74.

5. REFERENCES

DEAN, J.: Is the European Common Currency Worth It? Challenge. May/June 1997.

FATÁS, A.: Does EMU Need a Fiscal Federation? INSEAD and CEPR 1997. Fountainbleau, France.

PALÁNKAI, T.: Az Európai Unió költségvetése. Európa Expressz Konferencia II. Budapest, 1999.

Postwar lessons for budgetary policies in EMU. New Political Economy, November 1997.

RICCI, L. A.: A Model of Optimum Currency Area, IMF, 1997.

The euro's first test. The Economist, January 9, 1999. Section: Finance and Economics.

TÖRÖK, Á.: Bevezetés a komparatív előnyök elméletébe, KKF, 1995.