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The Eurozone: Problems and Prospects

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The Eurozone: Problems and Prospects

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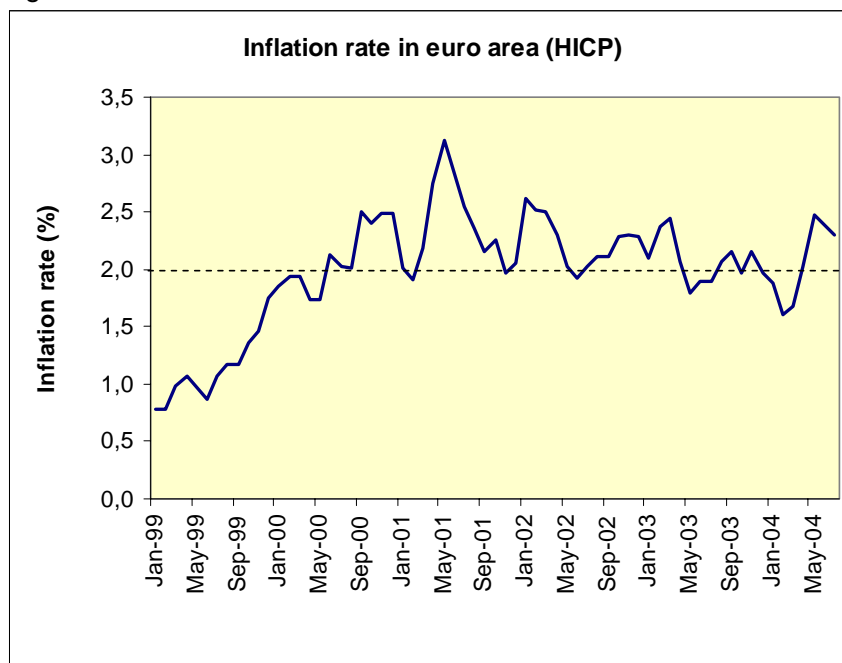
The creation of the euro was a major historical event in the process of European unification, and the very fact that it happened is a positive surprise. Fifteen years ago few people would have thought this would be possible. I remember 15 years ago most economists were extremely sceptical about the prospects of the euro. They thought it would never work, yet here it is, and it has been with us for a couple of years, which is a remarkable achievement.

There have been other surprises about the euro, some positive, others negative, that I want to analyse, and to come to some more prospective analysis about the future.

Positive surprises

Let us first look at the positive surprises. The first that comes to mind is the fact that the ECB has been very successful in maintaining low inflation, close to 2% (see figure 1). As a result, the ECB has established a strong reputation for price stability. It has also anchored expectations such that now the market is convinced that inflation will be around 2%.

Figure 1



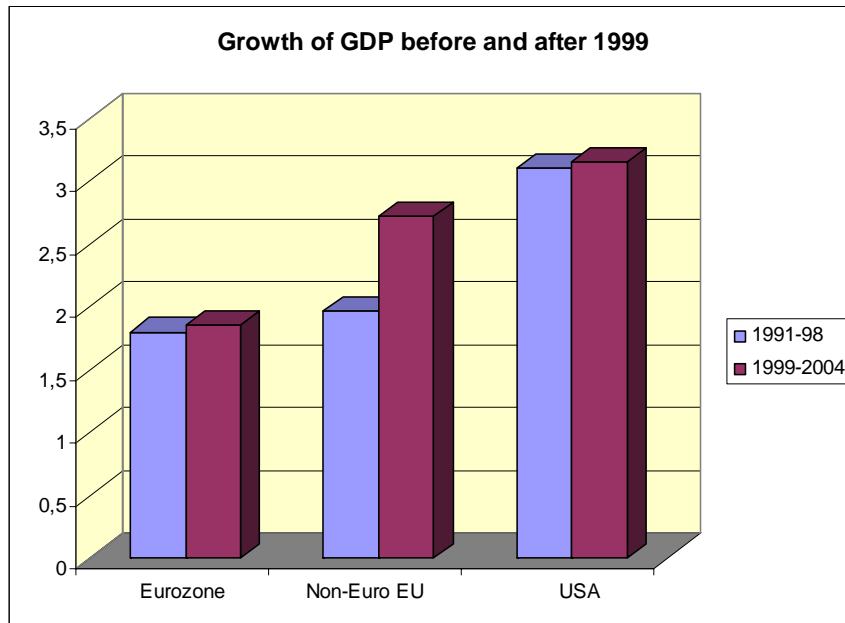
Source: ECB: Monthly Bulletin

Another positive surprise has been the intensity of financial market integration, specifically, money and bond markets have now been fully integrated. In many investor portfolios on the European Continent, the home market bias that was typical in the past, has disappeared or is in the process of disappearing, and all this has led to an increase in the size of capital markets and is leading to a reduction in the cost of capital. These are all positive developments that we have as a result of the euro.

Negative surprises

Let me now look at the less happy surprises. The first I will focus on is the low growth performance of the Eurozone. Again, expectations were very different when the Eurozone started. The way the euro was positioned was very much in terms of promising a growth impetus in Europe, a win-win thing that raised expectations about monetary union. Unfortunately, this has not come about, as is evident from figure 2.

Figure 2

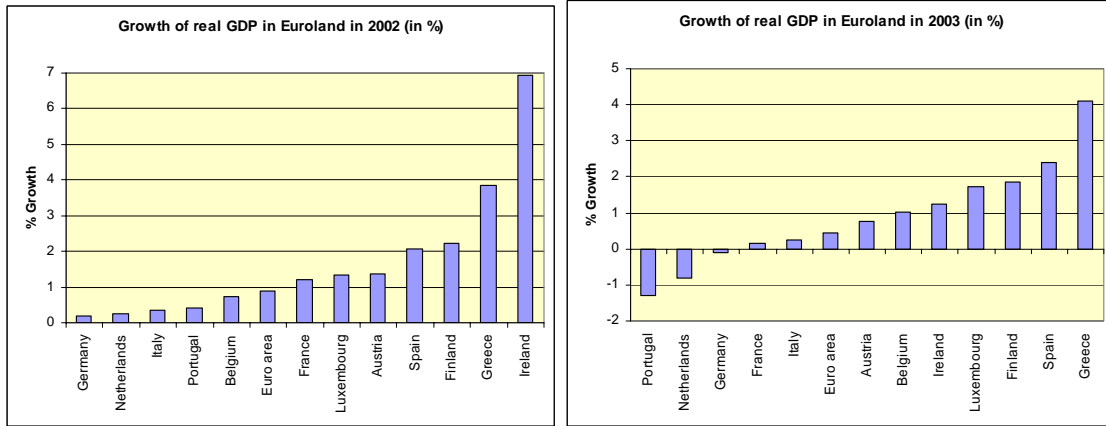


Source: European Commission, European Economy, Statistical Annex.

This graph compares three groups of countries: the Eurozone; the non-euro EU, which is the group of countries outside the Eurozone but belonging to the EU, essentially United Kingdom, Denmark and Sweden; and then the US. What we see is, first of all, that the Eurozone has maintained a low growth performance following monetary union and, more surprisingly, that those countries which decided not to enter the Eurozone improved their growth performance on average compared to the Eurozone countries. That is certainly a surprise; few people would have expected this to happen at the start. Then of course, the US has a growth performance that has been higher both before and following the start of the Eurozone.

Another unpleasant surprise is the degree of divergence, what economists call 'asymmetric shocks'. During the last few years we have seen quite large divergences in economic performance. Here I show the growth of real GDP in the Eurozone in two years, 2002 and 2003, and as you can see, these differences have been substantial, with some countries experiencing a recession or near-recession and others a strong boom in economic activity. This is certainly something we did not anticipate, at least not the intensity of this, and, as I will argue later, this is one of the major reasons why it has been so difficult to have a monetary policy at the level of the Eurozone.

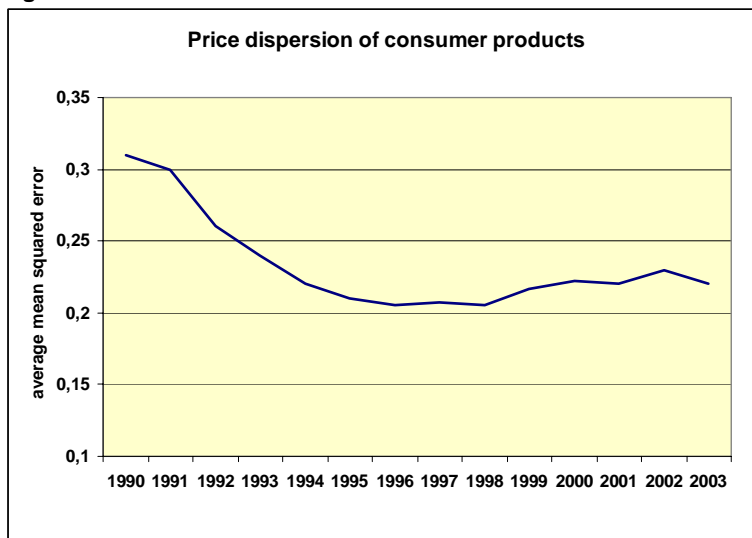
Figure 3



Source: European Commission, European Economy, Statistical Annex.

Other unpleasant surprises have to do with price convergence. Again, here the expectations were that the euro would introduce more price transparency, that is, consumers would be able to compare prices better because they would be expressed in the same currency. As a result, they could shop around more, which would lead to a convergence of prices at the micro level, i.e. the same products would have the same prices everywhere because of this euro effect. This would lead to more competition and a lowering of prices, which would benefit consumers. The trouble is that it has not happened. In figure 4 I show the result of a recent study by Engel and Rogers. What these authors did was to compare prices of individual products at the micro level, comparing the prices of the same products in cities of the Eurozone, and then computing the measure of dispersion of all these bilateral price comparisons.

Figure 4



Source: Engel and Rogers, Economic Policy, 2004

We observe from figure 4 that since the start of the euro there has been no price convergence. The euro has not worked in terms of bringing prices of the same products together. Arbitrage, in other words, has not been more forceful as a result of the euro. Surprisingly, such price convergence happened prior to the start of the euro, namely in the first half of the 1990s. The interpretation is that what happened in those days was the internal market, which eliminated many obstacles to trade and arbitrage. The internal market was a much more forceful dynamics in bringing prices into convergence at the micro level. The euro has been too weak a force to do that. In a way this is not surprising,. Transaction costs are quite important at the retail level, and the fact that people do not have to translate prices in different currencies does not change much.

The bottom line of this analysis is that on the one hand, the euro has been a great financial and monetary success; it has become popular in financial markets and in banking circles, but this success does not seem to have been translated into the real part of the economy, that is in terms of economic growth and employment. As a result, for many people today who are concerned about their economic future, the euro is not associated with a success story.

Growth Performance

The question that arises is where the contrast between financial success and lack of economic success comes from? I will focus here mostly on growth performance to analyse this question.

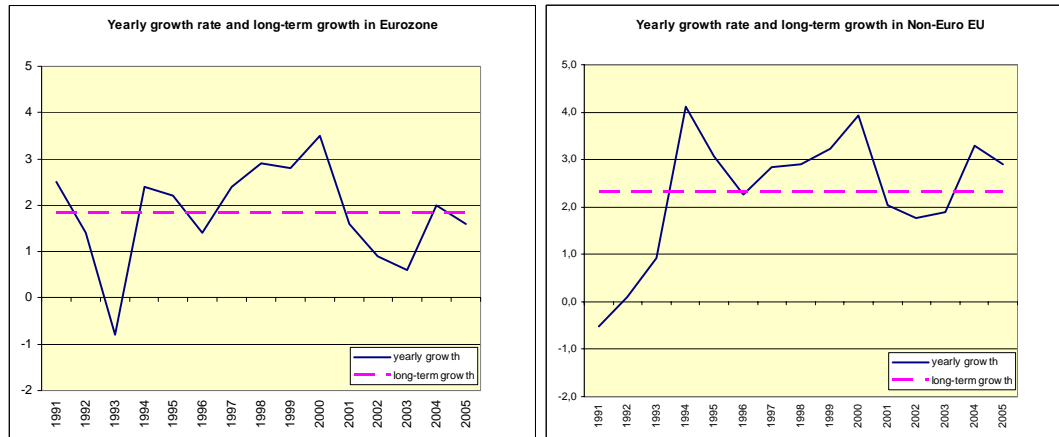
Two stories can be told. One is the story that we hear from Frankfurt: if there is slower growth performance in the Eurozone, it is all structural. It has to do with the fact that there are rigidities in the Eurozone and these things have nothing to do with the euro, and nothing to do with the ECB, which is totally incapable of dealing with this problem. Another story is a Keynesian one. This is that there is a flaw in macroeconomic demand management at the Eurozone level.

My conclusion will be that, as so often in economics, there is a mix of the two stories: there is a problem of structural rigidities, but also a problem of macroeconomic management, a cyclical problem.

Structural versus Cyclical

Let me try to disentangle the structural from the cyclical component. The way I want to do that is by comparing the Eurozone, which is the left-hand side in figure 5, with the non-euro EU – that is the UK, Sweden and Denmark (the right hand side of figure 5). Figure 5 presents the yearly growth rates of GDP and the long term growth rate, which is obtained by a trend line, in both groups of countries. We observe that there seems to be something structural going on, namely the fact that the long-term growth potential of the Eurozone is below that of the non-euro EU since the early 1990s. So there is something to the structural rigidity story.

Figure 5



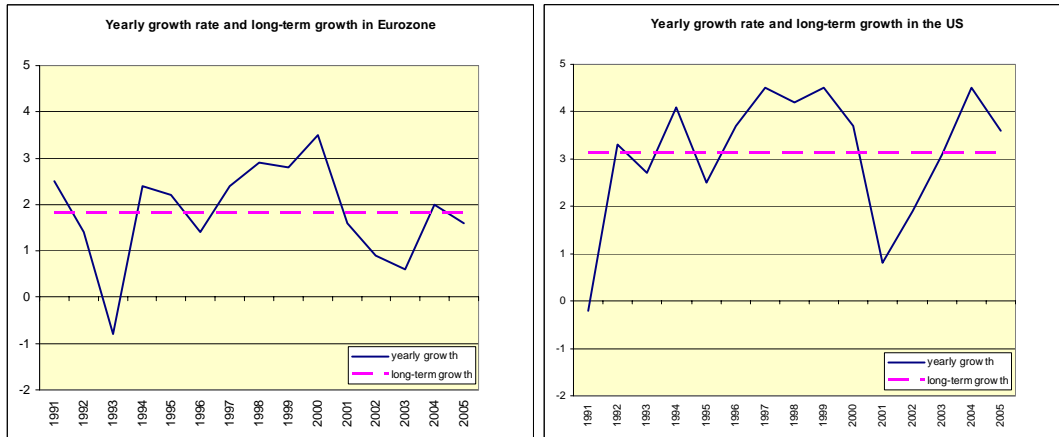
Source: European Commission, European Economy, Statistical Annex.

That is not the whole picture, though. We also see from figure 5 that since the start of the euro, output growth in the Eurozone has been consistently below its long-term potential. In other words, in contrast with the non-euro EU, the Eurozone has not been able to pull itself out of the recession and above its long-term growth rate. The contrast here with non-euro EU is strong, where one can see that these countries were capable of moving above the long-term growth potential since 2001. Thus it appears that there is something about the macroeconomic management at Eurozone level in addition to a structural rigidity story.

When we compare the Eurozone with the US, we find something similar (see figure 6), an even stronger difference in terms of long-term growth potential. In the US long-term growth is around 3% while it is only 1.8% in the Eurozone, but then again, a cyclical component, the strong ability of the US to pull itself out of recession and an inability to do so in the Eurozone.

Thus the structural rigidity story is certainly part of the analysis, and explains the lower growth potential of the Eurozone, but, as I have argued, it is insufficient to explain the continued slowdown since 2001. There is also a problem of stabilisation.

Figure 6



Source: European Commission, European Economy, Statistical Annex.

Stabilisation

Let us look at the problem of stabilization in the following way. In figure 7 the output gap numbers are compared for the eurozone and the non-euro EU. These output gap data are defined here as the yearly growth rates of GDP minus the long-term. Thus the zero line is just the situation where growth is at its potential. The contrast again is very striking. In the non-euro EU it has been possible to get out of the recession of 2001 quickly; in the Eurozone this does not seem to have been the case. Part of the low growth in the Eurozone is due to a structural component but the other part is clearly due to stabilisation failures.

A similar story can be told when one compares the US with the Eurozone. I show the same kind of numbers in the right hand panel of figure 7, i.e. the output gap for both the Eurozone and the US. We obtain a similar contrast.

Figure 7



Source: European Commission, European Economy, Statistical Annex.

From the preceding analysis I conclude that there is more than a structural rigidity story to explain the growth shortfall in the eurozone since 2001

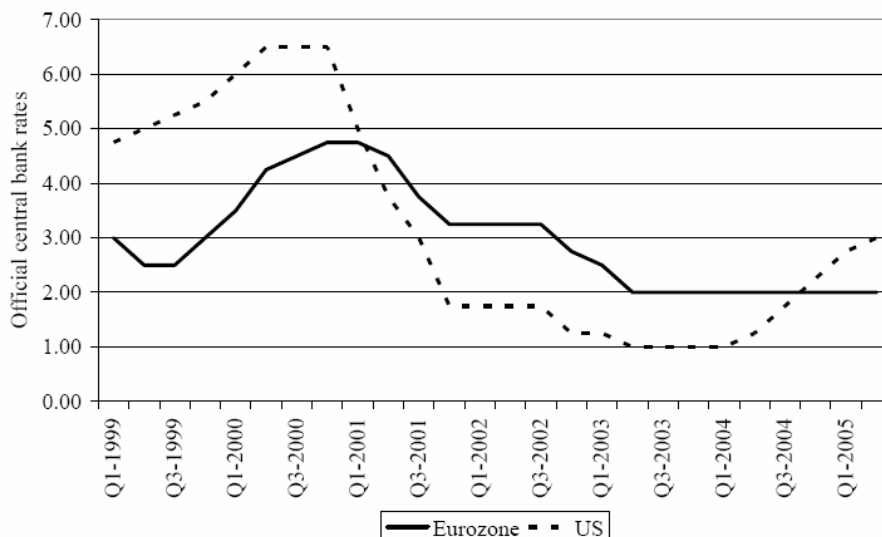
Flaws in Macroeconomic Management

The difficulties the eurozone experienced have much to do with flaws in macroeconomic management in the Eurozone. I concentrate on monetary and fiscal policies.

Monetary Policy

When we look at the monetary side of the equation, we find a striking difference between the Fed on the one hand and the ECB. Figure 7 presents the central bank rates for the Fed and the ECB since 1999. We observe the much more aggressive interest rate cuts in the US after the recession of 2001 than in the eurozone. In general there is greater activism of the Federal Reserve compared to the ECB.

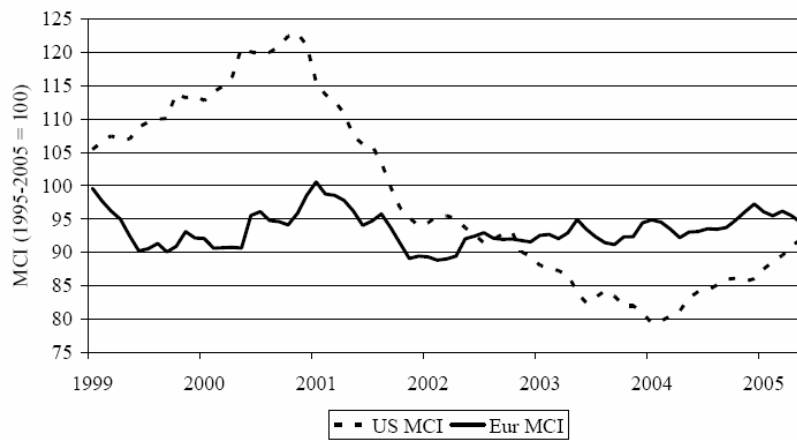
Figure 8: The contrast between the ECB and the FED



Sources: ECB and Federal Reserve.

Another indicator that tells a similar story but in a more striking manner is the monetary conditions indicator, which is an average of short-term interest rates and the exchange rate changes (see figure 9). We observe that the monetary conditions indicator for the Eurozone is essentially flat throughout the whole period. Thus despite a recession, there was no net stimulus coming out from the monetary field. The reason is that during the period 2001-03, when interest rates declined in the Eurozone, the euro appreciated vis-à-vis the dollar. The latter tended to compensate whatever monetary stimulus was exerted by the ECB. As a result, there was no net monetary stimulus being applied at the Eurozone level during the whole of the period here. The contrast with the Federal Reserve is again very strong, where we see that both the interest rate and the exchange rate movements were going in the same direction of sustaining economic activity.

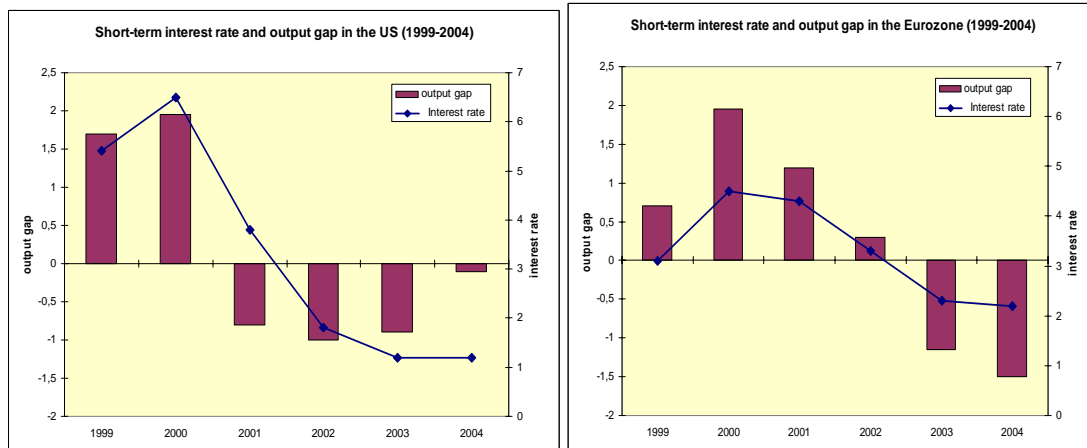
Figure 9 Contrast is even stronger when comparing MCIs



Source: Deutsche Bank.

Another way to look at this is to put together the interest rates and output gaps. This is done in figure 10 for the US and the Eurozone. We observe that the Fed was certainly more aggressive compared to the ECB in lowering interest rates. The Fed went much further in sustaining economic activity. In contrast the timidity of the ECB is striking. The ECB has not gone into the same deep territory of lower interest rates in order to sustain economic activity.

Figure 10: Short-term interest rate and output gap (1999-2004)



OECD, Main Economic Indicators

Difference in Approach of Federal Reserve and ECB

From the preceding analysis one can conclude that the ECB has been more cautious than the Fed in fighting the economic slowdown. The question that arises is why this is so? I would like to identify four factors that have turned out to be important. One is the difference in mandate; two, the need for the ECB, as a new institution, to establish credibility as being tough on inflation; three, a different underlying theory, monetarist in Europe, very Keynesian in the US; four, the asymmetry in the monetary union, of which I

have already given some evidence, which has led to paralysis of monetary policies. Let us look at these different factors.

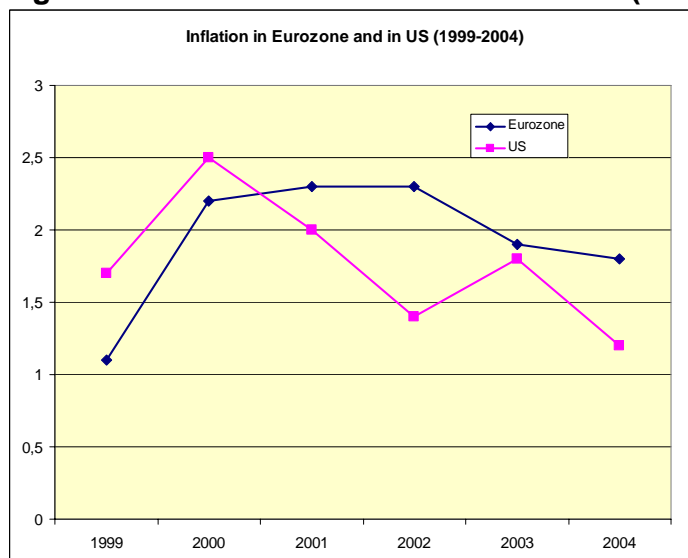
Mandate

First, there is a difference in mandate. The Fed's mandate is described in the Employment Act of 1946. This mandates the Fed to care about economic activity as well as price stability. In contrast, the mandate of the ECB is much more focused on price stability. I do not want to over-emphasize this because this is a legal difference; practice evolves and there is probably also some convergence in what these central banks are doing. Nevertheless, there is a difference in the legal mandate of the two institutions that can affect their behaviour.

Credibility

The second factor that I would like to stress is the desire of the ECB as a new institution, to establish a low inflation credibility. Surely, the ECB has been quite successful in creating such a reputation for itself. At the same time, however, it has overdone it by defining an inflation target that is clearly out of line with what other central banks are doing. By defining a target of a maximum of 2%, it has created a problem that was unnecessary. In particular, during the start of the slowdown, 2001-02, when inflation in the Eurozone was 2.3%, it paralysed the ECB, creating a perception in that institution that 2.3% is an excessive inflation rate and that therefore one should not try to be too aggressive in stimulating the economy. This is policy reaction was the result of a wrong target that needlessly traumatised the ECB. I will come back to that because it also has implications for the kind of flexibility we would want to have in a monetary union. The very fact that the inflation target has been set so low also creates structural problems.

Figure 11: Inflation in Eurozone and in US (1999-2004)



Source: European Commission, European Economy, Statistical Annex.

Different paradigms

There are different paradigms in the US and the Eurozone. Surprisingly the Fed has shown to be strongly Keynesian, and has been willing to use very Keynesian policies to combat the economic slowdown in the US. In contrast the ECB has been an adherent of a strong form of monetarism, which says that should not be concerned with output stabilization. All it has to do is to stabilize the price level. In so doing it makes the best possible contribution to output stabilization that a central bank can do.

Asymmetries in business cycle

Let me turn then to the last of the four factors, the asymmetries in business cycle developments. We have already observed from Figure 3 that there are strong divergences in growth performance within the Eurozone. While some countries experience a recession, others experience a boom.

These divergences bring us back into the basics of optimal currency areas. We know that currency unions are fine if there are not too many asymmetric shocks. If there are too many asymmetric shocks, then there will be problems in monetary union, except if countries have sufficient flexibility in their labour markets that allow them to deal with these shocks.

At this moment there is a wide range of experiences in output developments that is making it difficult for the ECB to react appropriately to the slowdown in the Eurozone during the recent period¹.

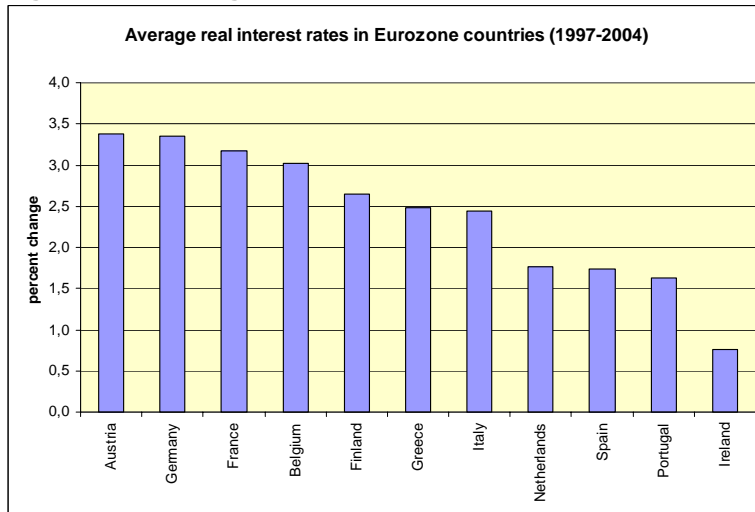
There are other asymmetries that complicate monetary policies in the Eurozone. One has to do with the fact that there are also large inflation differences. Since nominal interest rates are the same in the Eurozone this creates large differences in real interest rates with spill-over effects in the housing markets.

Figure 12 shows the differences in real interest rates in the Eurozone since the start of the Eurozone. Some countries have experienced relatively high real interest rates. In countries like Austria, Germany and France, real interest rates exceed 3% on average throughout this period, while in other countries like Ireland and Portugal they have been relatively low.

The large differences in real interest rates is one of the reasons why the Eurozone experienced a great divergence in house prices, with some countries like Spain and Ireland experiencing a doubling or almost a tripling of house prices during the same period, while in other countries like Germany house prices actually declined (see figure 13).

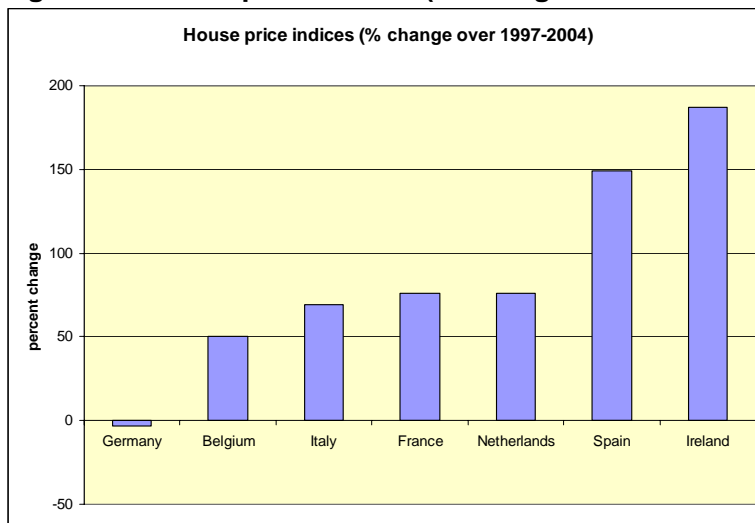
¹ It is often argued that the divergences in output and price developments between the states of the United States are of a comparable magnitude as in the Eurozone. This is undoubtedly true. It is also true, however that the degree of labour market flexibility is significantly higher in the US than in the eurozone. As a result, the US is better equipped to deal with the asymmetric output and price developments than the Eurozone.

Figure 12: Average real interest rates in Eurozone countries (1997-2004)



Source: European Commission, European Economy, Statistical Annex.

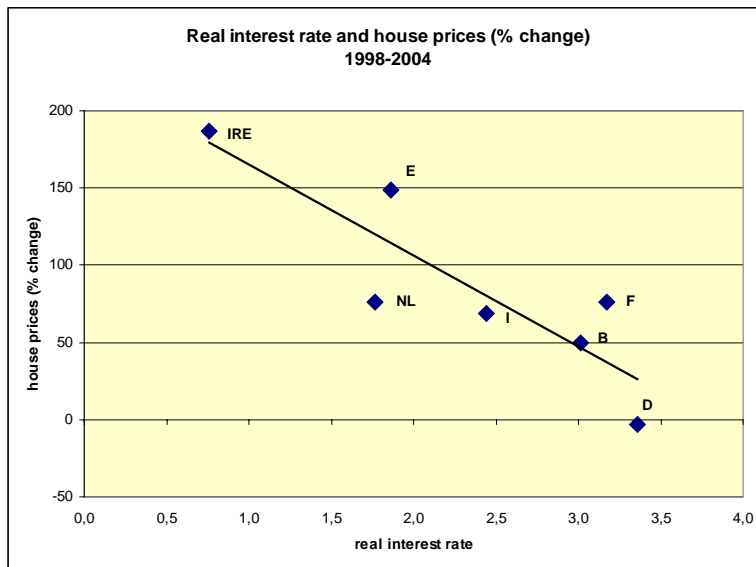
Figure 13: House price indices (% change over 1997-2004)-



Source: The Economist

The same information as in figures 12 and 13 is synthesized in figure 14. On the vertical axis we set the change in house prices from 1998 to today, on the horizontal axis, the average real interest rate during that period. We observe a negative relationship suggesting that countries that have experienced low real interest rates have had very strong housing booms while others, with high real interest rates, did not experience this.

Figure 14: Real interest rate and house prices (% change) 1998-2004



Sources: The Economist and European Commission

These asymmetries create problems for monetary policy at the Eurozone level. The existence of such large asymmetries inevitably leads to different perceptions of the representatives of the different countries in the Governing Council of the ECB as to the right kind of monetary policy to be applied at the Euro-area level. The decision process will be difficult, and is likely to lead to paralysis at the level of the ECB.

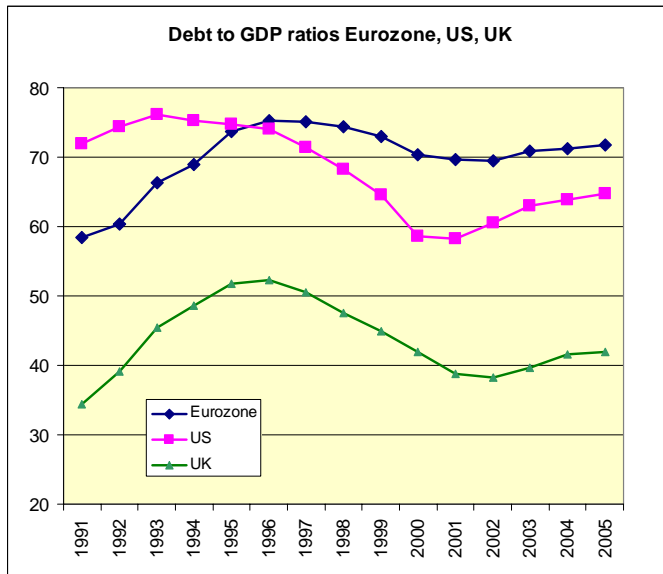
Fiscal Policy

What about fiscal policies? I have emphasized monetary policies. It is time to turn to fiscal policies. I will be briefer but I will claim that we have a similar paralysis at a fiscal policy level.

Debt to GDP Ratio

Figure 15 presents the debt to GDP ratios in the Eurozone, the US and the UK. The surprising thing is that since its start the Eurozone countries have on average kept their debt to GDP ratios practically unchanged. There has been only a small increase recently, despite the fact that the Eurozone has experienced a strong recession. Thus here we have a situation where the fiscal authorities have not reacted to the slowdown of economic activity. This stands in contrast with the US, where we have seen a strong increase in the debt to GDP ratio as a reaction to the slowdown in economic activity. Something similar, although less pronounced, has been going on in the UK, which has not hesitated to use Keynesian fiscal policies in contrast to what has happened in the Eurozone.

Figure 15: Debt to GDP ratios Eurozone, US, UK



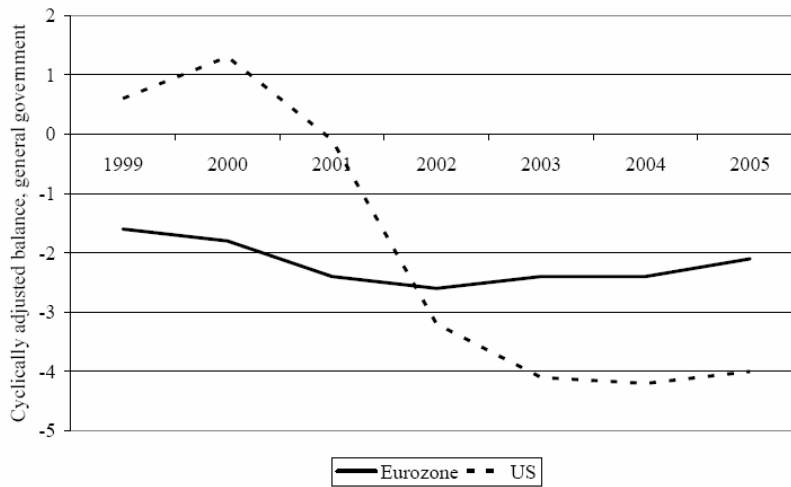
Source: European Commission, European Economy, Statistical Annex.

Cyclical Adjustments

Another way to look at the same problem is to analyse the cyclically adjusted deficit, which takes out the effect of the business cycle on the budget deficit. This is done in figure 16. The cyclically adjusted budget deficit in the US has been extremely volatile, reacting very strongly to the slowdown in economic activity, especially in the period 2000-03. This surely helped to sustaining economic activity. In contrast in the Eurozone there is almost no movement in the cyclically adjusted budget deficit. It should be pointed out that in the Eurozone the data underlying figure 16 are the sum of the national budget deficits while in the US these data concern the federal government budget deficit. Nevertheless, it can be concluded from the evolution of the aggregate of fiscal policies in the Eurozone, that fiscal policies have not been used as instruments to stabilize the economy. This stands in stark contrast to the US and the UK experiences.

Why has this been the case? Why have Eurozone countries failed to follow counter-cyclical budgetary policies, in contrast with what other countries have been doing? The first reason, of course, is the legacy of the past, i.e. the Eurozone started with a relatively high debt levels, making it more difficult to have the same kind of policies as in the US or in the UK. A second reason has to do with the existence of the Stability Pact, which in my opinion has put an excessive focus on what I would call 'holy numbers' like the number 3. This focus on numbers that have no rational foundation has prevented policymakers from acting rationally. As a result, the Stability Pact has also paralysed fiscal policies – I would argue needlessly – in a number of countries. Of course, in a country like Italy and Belgium, with high debt levels, I would argue that there was no way to use of Keynesian fiscal policies, but in other countries such as France or the Netherlands, there was scope to do so, but policy-makers were constrained by rules that have no rational or scientific basis, and that unfortunately continue to guide the minds of otherwise intelligent people in Europe.

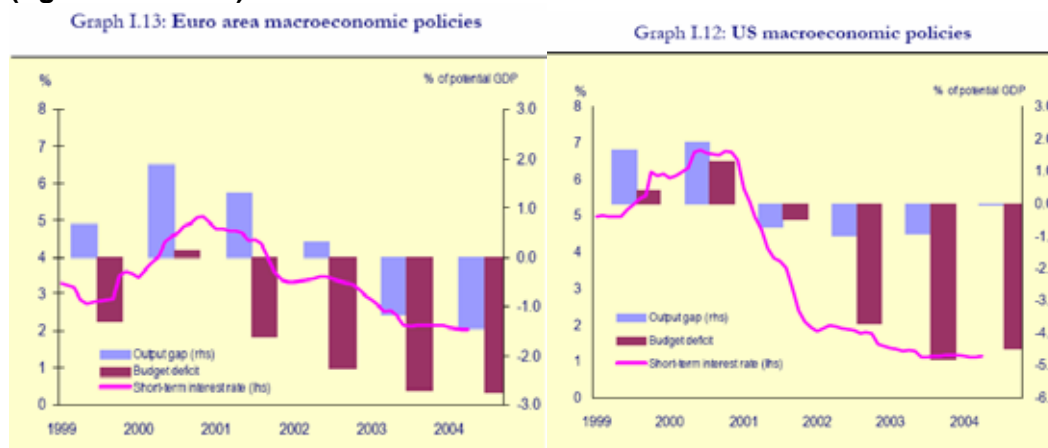
Figure 16: Cyclically adjusted deficits: activism in US and paralysis in Eurozone



Source: European Commission.

The contrast in macroeconomic management (monetary and fiscal policies) between the US and the Eurozone is neatly summarized in figure 16, which shows the budget deficit, short-term interest rates and output gap. In the US both the instruments of monetary policy and fiscal policy have been used in a much more aggressive way than in the Eurozone. Of course, some will say that the US authorities have gone too far in using Keynesian monetary and fiscal policies and that in the end these will turn out to be the wrong policies. The future will tell; till now we have not seen anything resembling disaster. In the Eurozone I would argue we have just been too timid.

Figure 16: Macroeconomic policies in the Eurozone (left hand chart) and the US (right hand chart)



Source: European Commission

The Future for the Eurozone

Let me now turn to the second part of this lecture, which is about the future. Let me start by stressing that the present situation is a dangerous one in the sense that the euro, which was full of promise and positive expectations, has not provided clear benefits for a significant number of countries in the Eurozone. I am thinking of Italy, Germany, Netherlands and possibly others. In fact, in these countries the Eurozone is perceived to have contributed to the economic slowdown.

Divergences

This state of affairs has much to do with divergent economic developments within the Eurozone which, as I have argued, have paralysed the ECB and led to a failure to stabilise the Eurozone business cycle. Some of these divergences are structural, others have a political origin. Here we come to one of the major problems facing the Eurozone. On the one hand, we have a situation where monetary policies have been fully centralised in the Eurozone, while at the same time the other components of economic policies that affect macroeconomic conditions have remained almost 100% at a national level. I am thinking of spending and taxation, social policies – the 35-hour week in France, for example, is a nationally decided policy – wage agreements, and housing policies. These are all decided at a national level and they are sources of asymmetric shocks, which continue to lead to divergent economic developments within the Eurozone. This is unlikely to stop as long as we maintain this particular set-up where most economic policies with macroeconomic content are in the hands of national policymakers.

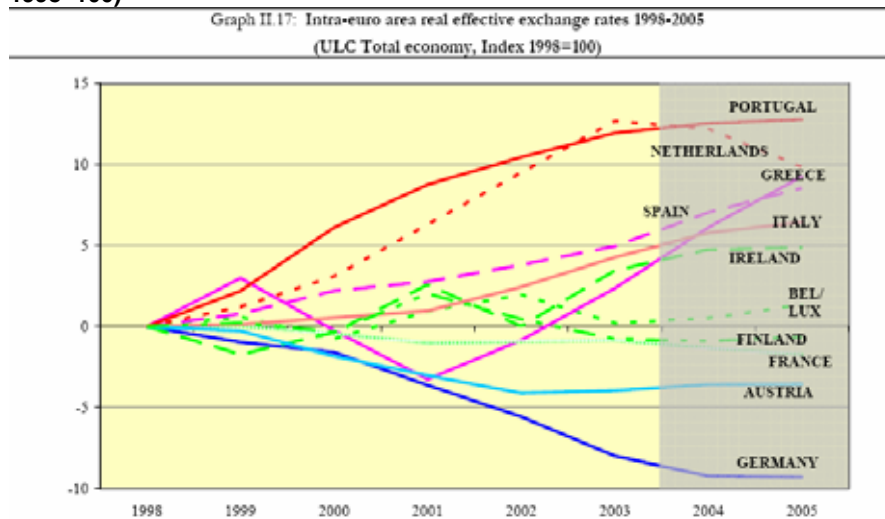
These divergences in fact are likely to accumulate over time. This is well illustrated by the trends in relative competitiveness. In figure 17, the real effective exchange rates of the Eurozone countries are presented. One can see that there has been quite a strong divergence in these real exchange rates with some countries experiencing a loss of competitiveness, Portugal, Netherlands, Greece, Spain and Italy are facing an increasing loss of competitiveness, while others have gained in competitiveness. If this continues, it creates a potential for conflict and tension within the Eurozone that we have to face, especially if some countries find it difficult to correct any loss of competitiveness².

Let me take the example of Italy, which is now in a situation where it has lost competitiveness, especially vis-à-vis Germany, which will have to be corrected. As is well-known, in a monetary union, there are few instruments to do so: devaluation and national monetary policies are not an option. As a result, the only option for a country like Italy is to go through a process of deflation, i.e. trying to bring inflation below the average. However, since the average inflation rate is quite low because the ECB is targeting an inflation rate that in my opinion is too low, the process of deflation is stretched over a long period of time. If Italy has to correct, say, a 15% loss of competitiveness and the average inflation in the Eurozone is 2%, it must lower its inflation below 2%. Since at the same time Italy should avoid to have a negative inflation rate, the yearly corrections that can be made are of the order of 1-2% at most. This is really imposing deflationary policies over a long period of time, creating costs in terms of unemployment. It is clear that this will reinforce the perception that the Eurozone does

² Part of these divergent real exchange rate developments may be related to the Balassa-Samuelson effect, which predicts that countries that experience high growth rates of productivity will see their currency appreciate in real terms. This effect may have played a role in countries like Greece and Ireland, but are unlikely to be strong in the Netherlands, Spain, Portugal and Italy.

not favour Italy. This could lead to the temptation to leave the union. This temptation will be all the stronger as the monetary union is not embedded in a political union.

Figure 17: Intra-euro area real effective exchange rates 1998-2005 (ULC total economy, index 1998=100)



Source: European Commission

Monetary Union without Political Union

The previous analysis leads me to the next and last question: can a monetary union survive without political union? There are important interactions between monetary and political integration that I would like to highlight in answering that question. These interactions have two sources. One is that political union makes it possible to organize fiscal transfers, which provide some insurance against asymmetric shocks. By that, we mean that if a country is experiencing negative economic developments, in a political union you will also have a central budget that automatically transfers from countries experiencing good times to countries experiencing bad times. This is an important element that will tend to lower the perception of the cost of a monetary union.

The other point of interaction is, as I already hinted at, that a political union reduces the risk of asymmetric developments which have a political origin, like spending and taxation decisions, wage policies, social policies. As long as these decisions are national, they create potential sources of divergence. Political union, by co-ordinating these decisions, reduces the risk of such divergent movements that are very difficult to correct in a monetary union. That is the importance of the link with political union. I would argue that a political union increases the long-run sustainability of a monetary union.

Let me put it in the following and somewhat different way. A few weeks ago, Claude Trichet, the president of the ECB, was asked the question what he thought about the prospect of Italy leaving the Eurozone. He answered by saying 'That is an absurd question. It is as absurd as asking the question what would happen if California decided to dump the dollar and to take another currency.' The fact is that it is not an absurd question. The situation between California and Italy is very different. In California we

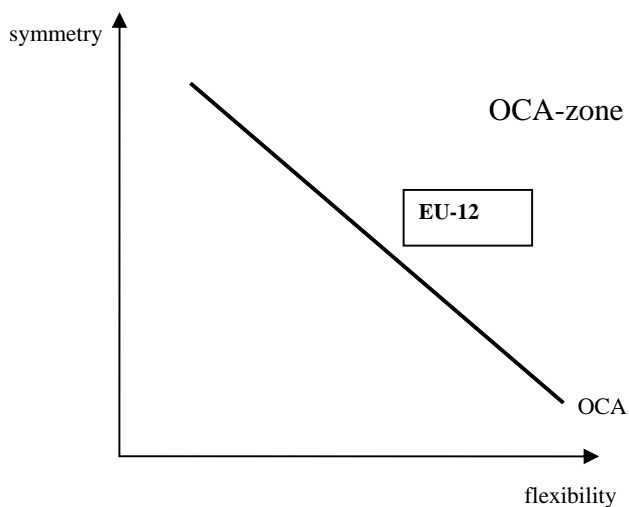
face the situation of a federal government with the monopoly of coercive power that is capable of, and certainly willing to bring back all the states that might like to get out of the monetary union. So if the Governor of California decided to dump the dollar, one can be sure that the US federal government would step in and take over the governance of California.

No such thing exists in Europe. If Italy were to decide to move out, there is no coercive power that can force Italy to stay in. Therefore it is essential that the cost/benefit balance of the monetary union for Italy is always right, that is, that Italy perceives that its being a member of a monetary union has more benefits than costs, so that it will willingly stay in the monetary union. In fact, monetary union in Europe is a contract between sovereign nations that willingly stay in the union, and therefore the benefits must exceed the costs. If we get into a situation where the perception that the costs exceed the benefits is strong and is maintained, then the temptation for these countries to get out will be overwhelming and nobody can stop them from doing so. That is, I think, the essence of the problem. We need to embed the monetary union into a political union for the economic reasons that I developed but also for the reason that we need a link and a cohesion in the group of nations forming a monetary union so that the temptation to leave the union will be lower.

The following figure 18 presents a framework to analyse the connection between monetary and political union. It presents the minimal combinations of *symmetry* and *flexibility* that are needed to form an optimal currency area by the downward sloping OCA-line. Points on the OCA-line define combinations of symmetry and flexibility for which the costs and the benefits of a monetary union just balance. It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility. To the right of the OCA-line the degree of flexibility is sufficiently large given the degree of symmetry to ensure that the benefits of the union exceed the costs. To the left of the OCA-line there is insufficient flexibility for any given level of symmetry.

The position of the OCA-lines in figure 18 depends on a number of factors. Here we concentrate on one factor that has received relatively little attention in the economic literature. This is the degree of political integration among the member countries of the monetary union. We take the view that the degree of political integration affects the optimality of a monetary union in two ways, as discussed earlier. First, political union makes it possible to organize systems of fiscal transfers that provide some insurance against asymmetric shocks. Thus when one member-country is hit by a negative economic shock, the centralized union budget will automatically transfer income from the member states that experience good economic conditions to the member state experiencing a negative shock. As a result, this member state will perceive the adherence to the union to be less costly than in the absence of the fiscal transfer.

Figure 18: Symmetry and flexibility as OCA-criteria



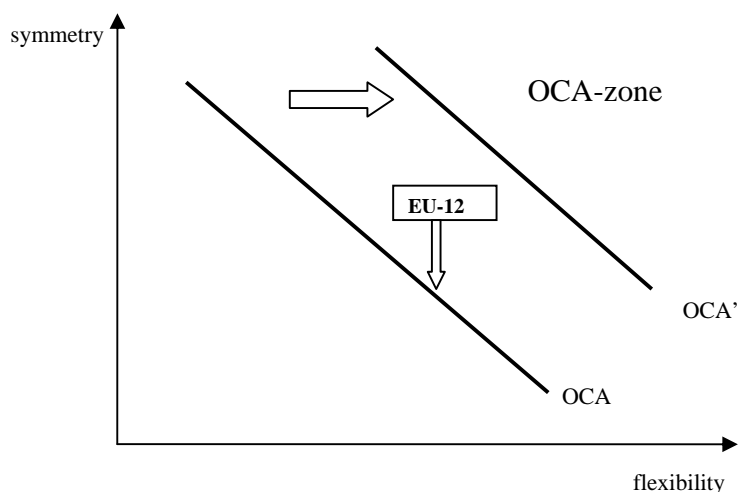
Second, a political union reduces the risk of asymmetric shocks that have a political origin. We have discussed these earlier.

The way one can represent the effect of political unification graphically is twofold. First, the existence of a centralized budget makes it possible to alleviate the plight of countries hit by a negative shock. Thus the cost of the union declines for any given level of asymmetry. This has the effect of shifting the OCA-lines downward in figures 1 and 2³. Second, political union reduces the degree of asymmetry, thereby shifting the Eurozone upwards. As a result, of these two shifts political unification increases the long-term sustainability of monetary unions. Conversely a political disintegration shifts the OCA-lines upwards thereby shrinking the OCA-zone and shifts the Eurozone downwards, creating the risk that the EU-12 ceases to be an optimal arrangement⁴. We represent the latter scenario in figure 19. A political disintegration shifts the EU-12 downwards and shifts the OCA-line to the right to the new position OCA'. As a result, it becomes more likely that the Eurozone ceases to be an optimal currency area, thereby undermining its long-term sustainability.

Figure 19: Political union affects OCA-line

³ It is important that these transfers be reversible to maintain their insurance character. If these transfers attain a permanent one way character they are likely to become unpopular in the "donator"-country, leading to a perception of a high cost of the monetary union. This calls for the use of transfers only to alleviate the effects of temporary asymmetric shocks (business cycle movements) or in the case of permanent asymmetric shocks to make these transfers temporary allowing receiving countries to spread the adjustment cost over a longer time.

⁴ For important additional insights into the link between monetary and political union see von Hagen (1996), where it is argued that political unification can also lead to increased tensions between member states. As a result, the link between monetary and political union is not a linear one.



Some thoughts about monetary unification in East-Asia

The Asian financial crisis of 1997-98 generated considerable turbulence. Many Asian countries found out that in a world of free capital mobility they were unable to fix their exchange rates. Speculative attacks in the exchange markets forced them to devalue or to let their exchange rate float. This led to large macroeconomic disturbances and to distortions in trade flows. Initiatives were taken to prevent this from happening in the future⁵.

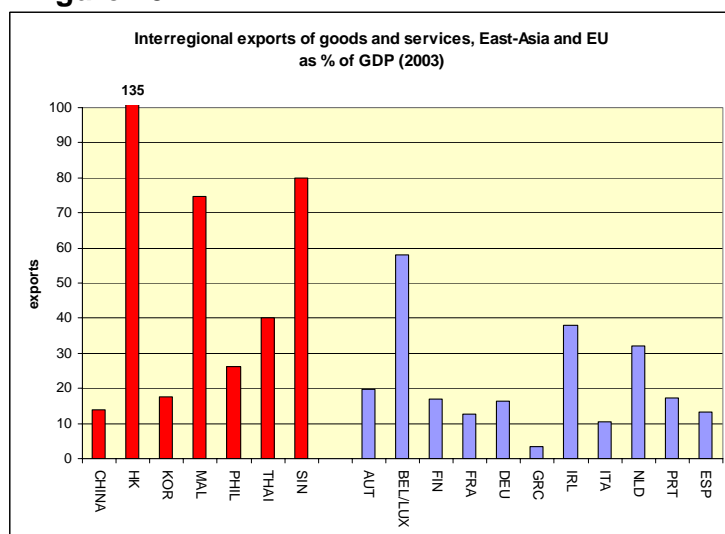
There is a widespread view however that these new financial arrangements will not suffice to shield the Asian currencies from future speculative attacks. As a result, the idea of permanently locking the exchange rates of these currencies by moving into a monetary union has gained credence. The question that arises then is whether Asia is ready for a monetary union. Or put differently is Asia an optimal currency area. We concentrate on East Asia here because this is the part of Asia that is most developed and where the financial crises of 1997-98 were felt most acutely.

We start by analyzing the evidence about the degree of trade integration and compare it with trade integration in the Eurozone. In figure 20 we present the exports of East-Asian countries to the rest of East-Asia as a % of their GDP and compare these with the exports of Eurozone countries with the rest of the union (also as a % of GDP). Asian countries have strong degrees of integration with the rest of Asia, very much like EU-countries have with the rest of the EU⁶. Thus an important OCA-criterion seems to be satisfied in East-Asia. These countries are highly integrated and should therefore profit a lot from the efficiency gains provided by having one currency.

⁵ The most important one is the "Chiang Mai Initiative" (CMI). The Finance Ministers of ASEAN, China, Japan and South Korea announced the initiative in May 2000. It expanded a network of bilateral short term credit arrangements among ASEAN countries, China, Japan and the Republic of Korea. The CMI also initiated an economic review and policy dialogue process, which aims at eliminating macroeconomic and financial disequilibria that may lead to crises (see Xu Ning(2004)).

⁶ Note also that some countries in Asia have extremely high integration ratios, in particular Hong Kong which has a ratio exceeding 100%. This is due to the fact that exports are production data (which include imports) while GDP are value added data (excluding imports). Hong Kong's export is to a large extent transit trade with little value added. As a result, it exceeds 100%.

Figure 20



Source: IMF, IFS and Xu Ning(2004)

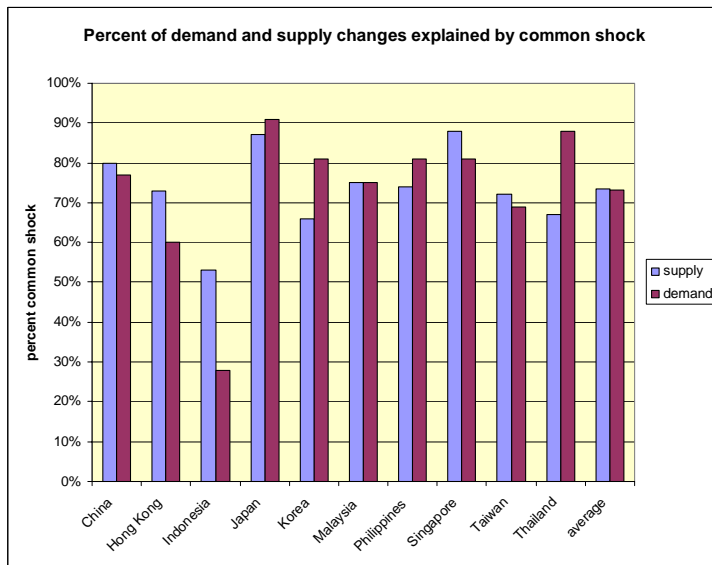
Note: the exports of the East-Asian countries are to ASEAN plus China, Korea and Japan. The data for China relate to 2001.

The second OCA-criterion we want to analyze is the degree of asymmetry of shocks. This has been analysed in great detail during the last few years. The consensus today is that Asian countries do not experience more asymmetry in their shocks than the present Eurozone countries (see Bayoumi and Eichengreen(1999), Yin-Wong Cheung & Jude Yuen(2003), Xinpeng Xu(2004) Kiyotaka Sato and Zhaoyong Zhang(2005)). The latter show that both the long term trend and the cyclical components of output are integrated. The study of Xinpeng Xu(2004) computes the percentage of the variation in demand and supply shocks that can be attributed to common shocks⁷. Thus this percentage can be interpreted as expressing the degree of symmetry in the shocks. We show the results in figures 21 and 22. Figure 21 shows these percentages for the Asian countries, while figure 22 shows these percentages for the Eurozone countries. It is very striking to observe that the degree of symmetry in the demand and supply shocks of Asian respectively Eurozone countries is very similar⁸. The degree of symmetry of shocks of the Asian countries appears to be only marginally lower than in the Eurozone countries (see the averages in the figures).

Figure 21

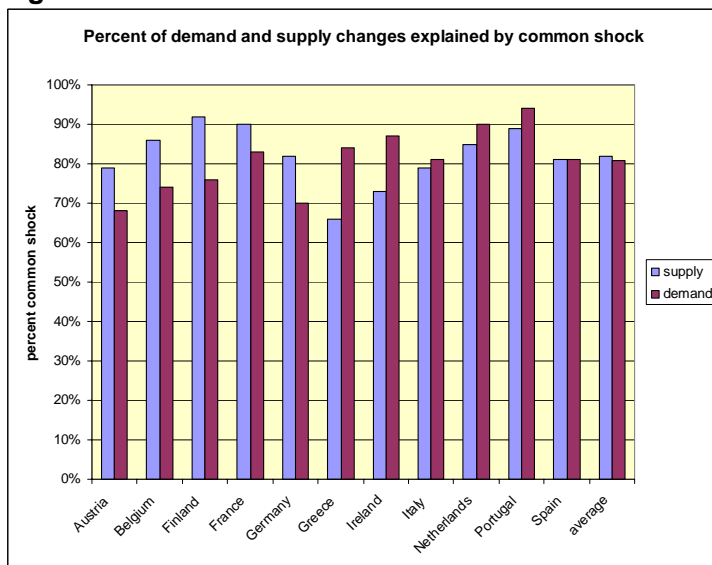
⁷ These percentages are computed by first extracting the demand and supply shocks using the Blanchard-Quah procedure (see box xx). Then these demand and supply shocks are subjected to a factor analysis which allows to extract a common component in the movements of these shocks.

⁸ The outlier is Indonesia whose demand and supply shocks so not seem to be well synchronized with the rest of Asia



Source: Xinpeng Xu(2004)

Figure 22



Source: Xinpeng Xu(2004)

We conclude that according to two of the OCA-criteria, East Asia seems to be close to an optimal currency area (assuming that the Eurozone is a good benchmark). In addition, since it appears that the flexibility of the labour markets in these countries is at least as high, if not more so, than in Europe (see Zhang, Sato and McAleer(2004), it appears that East-Asia comes close to forming an optimal currency area.

So, why has monetary union not come about yet in Asia? The answer seems to be political. There is a widespread feeling in East Asia that the political obstacles to forming a monetary union are too large. These obstacles are themselves the result of historical developments that make it difficult for these countries to unite. In addition, there are

large cultural differences that act as equally important impediments for a successful integration. The contrast with the European Union is important. Monetary unification became possible in Europe also because of a strong political desire to unite the continent. This desire originated from the Second World War and led to the build-up of European institutions like the European Commission, the European Court of Justice and the European Parliament that all embody some transfer of national sovereignty. In such an environment it became relatively easy to create a new supranational institution, the European Central Bank. This institutional infrastructure is still absent in Asia, making it difficult to envisage monetary union in the short and medium run.

The analysis of the Eurozone made in this paper strengthens this conclusion. Despite the considerably stronger political integration in Europe as compared to East-Asia, the present level of political integration is unlikely to be sufficient for the Eurozone to survive in the long run. A fortiori it follows that the political conditions for a successful monetary union in East-Asia are certainly not fulfilled.

Conclusion

Monetary union must be embedded in a political union because it permits the centralisation of national budgets and thereby facilitates some form of redistribution. This is important economically, because it lowers the cost of a monetary union. It is also important for political reasons. Redistribution and risk sharing within such a group of nations are essential to create a sense of belonging to the same group, which in turn is important to maintain the political will to stay in that union. Countries will not stay in the club if they are constantly told when they face economic difficulties that they have to get out of their economic problems on their own, without the help of the others. If that is the message the Eurozone countries today send Italy – and that is the message they are sending Italy – at some point the decision in Italy will be to get out of the union. I do not think this will happen in the next few years. I am just taking a long-term perspective and saying that, in the long run, we have to make sure that we embed the monetary union into a political union.

The other reason why a monetary union must be embedded in a political union is that the greatest source of asymmetric shocks in a monetary union now are political shocks. These result from different economic policies that are not co-ordinated.

The prospects for political unification these days do not look too good in the European Union. The recent 'no' votes on the constitution would seem to signal that Europeans do not want to move forward into a political union. One could even interpret this as signaling a reversal of the existing level of political union as each country returns to its own political cocoon. I know that there are also many local and national reasons why in France and Netherlands the 'no' vote won, but surely there is also dissatisfaction about the prospects of political unification.

All this could, of course, endanger the long-term sustainability of monetary union in Europe. Failure to move towards further political integration puts the Eurozone at risk. Let me conclude with the following metaphor. When we moved into the Eurozone, we moved into a beautiful house which lacked a roof. Without political integration, the Eurozone will be a house without a roof, which will become increasingly uncomfortable, so that many of the residents may at some point be tempted to move out of the house.

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