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Why are macroeconomic imbalances so important for the European Monetary Union?

*Roberto Tamborini**

According to a well established view of the crisis in the European Monetary Union (EMU), its seeds were planted well before the world financial collapse of 2007-08 and the subsequent Great Recession. The seeds, "macroeconomic imbalances" in the Brussels language, lie in the lack of real (and, to some extent, nominal) convergence across member countries. The idea is that as long as countries are on divergent trajectories of growth of GDP, productivity and incomes (and possibly price levels), 1) large and unsustainable current account imbalances will also emerge, 2) the ensuing capital movements may suddenly stop triggering bank and financial crises, 3) national fiscal policies will also be put under pressure by the need to bailout faltering banking systems while countries on a low growth path will also face harder convergence towards the 60% debt target, with higher interest rates and heavier fiscal effort.

The first issue of the *Annual Growth Survey* (EU Commission, 2011) was entirely devoted to pro-growth and convergence policies, and the surveillance on macroeconomic imbalances figures prominently among the new tools of European governance (EU Commission, 2010). "Formalising the convergence process" is the goal of Stage 2 in the road map towards "Completing Europe's Economic and Monetary Union" presented in the latest "Five President's Report" (Juncker, 2015). Higher growth across Europe is of course a valuable aim. However: are *convergent*, tendentially *uniform*, growth rates a *sine-qua-non* condition in a monetary union? Is there any economic tendency towards this outcome? Are, otherwise, such calamities as 1), 2), and 3) inevitable?

In order to address these issues it is natural, in the first instance, to look at long-standing large monetary unions. Table 1 reports basic data on the heterogeneity of real growth rates across US states and EMU member countries. In the 1990-2000 decade the min-max fork was larger in the US than in the EMU, and the standard

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deviation was the same. Later and up to the Great Recession, growth dispersion fell both in the US and in the EMU, though to a lesser extent. Overall, the EMU picture does not seem pathological with respect to the US, and possibly improving before the crisis.

Table 1: Growth statistics. US states and EMU12 member countries, 1990-2008

	US states	EMU12 members
1990–2000		
Min-Max	-1.4–6.9	1.6–7.1
Average	3.5	3.0
Standard dev.	1.6	1.6
2000–2008		
Min-Max	-0.4–4.1	1.3–5.0
Average	2.1	2.5
Standard dev.	0.9	1.2

Source: Statistical Abstract of the United States, and AMECO database

As to nominal convergence, i.e. the long-term trend of price levels, Darvas and Wolff (2014) show that sizeable inflation rate differentials across regions is a phenomenon that the EMU shares with other large monetary unions such as US, Canada, Australia. They also remind us that this phenomenon may be pathological, but not necessarily so, since it may reflect normal adjustment processes in growth catching-up or in the course of the business cycle.

Likewise, convergence to uniform growth rates is a rather peculiar requirement. None of the available explanations of growth attaches particular importance or a normative role to uniform growth rates across different countries or regions. The conventional wisdom among growth scholars holds that convergence, if it occurs, is a slow process even among regions in one national economy, and much slower than implied by theoretical models where mobility of labour, capital and technical knowledge should lead low-income regions to "catch up" with high-income ones (see e.g. Barro and Sala-i-Martin, 1991; Sala-i-Martin, 1996; Romer, 1994).

Traditional growth theory predicts that countries with similar technology and preferences will tend towards uniform per capita GDP levels, which imply uniform GDP growth rates only if population growth, too, is equal across countries. Implied by this long-run tendency (the so-called "s-convergence") is the so-called "b-convergence": the fact that, starting with unequal per-capita income distribution across countries, low-income countries grow faster - net of population - than high-income ones (Sala-i-Martin, 1996).

The so-called New Growth Theories have shown that if we abandon the assumption that the technical coefficient in the production function is constant, or that its changes are exogenous, and if we try to explain growth as an endogenous process (e.g. as a function of human capital accumulation), we may obtain divergence of per-capita income levels over time (s-divergence), which entails that rich countries may grow faster than poor ones (b-divergence). Moreover, endogenous growth may differ across countries for reasons other than human capital accumulation, such as different adoption rates of innovations or different R&D investments, and as a consequence countries may differ not only in their growth paths but also in their steady state values (see Bernard and Jones, 1996).

In summary, unequal GDP growth rates may well be associated with (i) rich countries identical in all respects other than population growth, or (ii) poorer countries "catching up" with richer ones, or (iii) rich countries getting richer, or (iv) different paths of technical progress.

With regard to the external imbalances associated with different growth rates, it may be recalled that the basic dynamic equation of external debt shows that external imbalances are sustainable as long as the growth rate does not fall short of the real cost of debt. In the early years of the EMU, the largest recipients of capitals in the "South" had both low real interest rates and high growth. From another point of view, Blanchard and Giavazzi (2002) argued that current account imbalances were consistent with a scenario like (ii), and that capitals flowing from slower-growing richer members to faster-growing poorer members were doing their job. Hence the calamities mentioned above are not inevitable, and they may occur not because of current account imbalances per se, but owing to other underlying factors, e.g. international capital market misallocations. It is always important to attack the causes, not the symptoms, of a disease.

The uniform growth presumption, or prescription, seems tailored to the scenario (i). Since population growth is conditioned by per-capita income levels, a small club of almost equally rich countries very similar in human and physical capital endowment and accumulation is more likely to display uniform GDP growth rates. This feature may be added to those that qualify an optimal currency area (OCA), and its absence boils down to the original objection that the EMU in its current extension is bound to fail because it is not an OCA. However, this conclusion is at variance with the historical evidence that the OCA requirements are seldom met in practice, while it is of little help in the search for the right institutional design of the EMU.

The usual puzzle is: since macroeconomic imbalances are so dangerous in a monetary union, how is it that nobody cares about them in the US or anywhere else? Of course, federal governments do care about growth, income or employment differences across

the federation. But their concern is motivated by the welfare of their citizens-electors, not by the *open-economy macroeconomics* textbook reasons put forward for the EMU, namely financing current account deficits. So here is a first clue to solve the puzzle: nobody in a federation thinks of it as a collection of open economies in a fixed exchange rate regime.

Indeed, financing current account imbalances in federal economies by way of private capital movements is one of the remotest concern one can ever think of. The reason is that in a federation financial integration is complete and failsafe. Payments within and across members take place through bank branches of a single banking system whose geographical distribution is immaterial (Goodhart, 1989). If a member (its local branches of the Bank Group A) loses money by way of its current account deficit, that money flows back as the headquarter of Group A redistributes the balances accruing in the branches located in the members with current account surplus. To the extent that the outflow of money goes from the branches of Bank Group A to those of B, the former can replenish their liquidity through the federal reserve system (where nobody quarrels about Target 2 imbalances). If loans to member X are misallocated to faltering economic units, the problem is between lenders and borrowers as in any ordinary risky transaction; if the borrowing units are "too big to fail" the problem is upgraded to the federal level. The Lehman crack was a US federal problem, not of the State of New York.

With regard to structural differences across the federation that may underlie current account imbalances, these, too, are mostly policy matters for the federal government. As is well known, estimates of the rebalancing of US state imbalances granted by federal mechanisms range from 30% to 50%. Individual states are not directly held responsible for, and in fact have few instruments to correct, their macroeconomic imbalances.

High concern with macroeconomic convergence is only one among a number of oddities that overwhelm the governance of the EMU and its members. So here is a second clue: the EMU is caught by such peculiar problems not because it fails as an OCA, but because it fails as an Optimal Federal Area. Everyone was aware of this original sin from the very beginning, and with great regret the bet that the creation of the monetary union would have paved the way to the other federal institutions has so far been lost. Consequently, EMU members remain entrapped in a tangle of rules whose rationale is not to govern a genuine monetary union but the European Monetary System 2.0, a Dr. Frankenstein's creature with a single monetary authority, irrevocably fixed exchange rates, and no common stabilization and rebalancing mechanisms.

Let me quote the words of Wolfgang Münchau in his column of November 1 on the *Financial Times* online:

"Advocates of the euro came from two different groups that struck a Faustian Pact. Members of the first group believed that the euro as constructed would fail, and hoped it would somehow be fixed. The others thought the system would stay rigid, *and bend the economies of its members in a new shape (my italics)*"

Bending and reshaping economies is an extremely difficult and dangerous task, and in the EMU we are probably approaching the limit. First, because history matters: economic systems are rooted in such deep factors as social habits, cultures and values, and there is no reason to believe or expect or prescribe that their development paths can easily be bent and reshaped to be alike. Second, there is a problem of legitimacy. Europe is ruled by the fundamental principles of democracy. It is a violation of these principles that a sovereign government is forced by external agencies, or even by other peers, to follow a specific policy strategy drawn from a particular view of the economy and society instead of another. This is not the kind of sovereignty devolution that can legitimately be asked to, and obtained by, any democratic government. If a particular economic system becomes dysfunctional, you should first get the right to change it by winning democratic elections for the government of that country, or the government of the United States of Europe whenever it will exist. If meanwhile the EMU as a whole is dysfunctional, well, let us unite our efforts to attack the causes, not the symptoms.

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- 3) capital markets and the regulation of the financial sector and
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