

European Integration in Crisis

edited by

Eckhard Hein, Jan Prieue and Achim Truger

Contents

Research Network	7
Introduction	11
Revival or survival of macroeconomic policy analysis in Germany? <i>Jürgen Kromphardt</i>	19
Reconsidering the theories of optimum currency area – a critique <i>Jan Prieue</i>	27
Fixed and flexible exchange rates and currency sovereignty <i>Claudio Sardonì and Randall Wray</i>	53
Currency unions: some lessons from the Euro zone <i>Charles A. E. Goodhart</i>	77
Economic divergence in the Euro area – why we should be concerned <i>Jan Prieue</i>	103
Wages and regional coherence in the European Monetary Union <i>Hansjörg Herr and Milka Kazandziska</i>	131
Reforms and continuity in the Italian economy: EMU at risk? <i>Stefano Solari and Claus Thomasberger</i>	163
How much room for expansionary economic policies in the EMU? The case of Spain <i>Jesús Ferrero, Carmen Gómez and Felipe Serrano</i>	195
Can the European construction really continue relying on the NAIRU? <i>Dany Lang</i>	221
Co-ordinating macroeconomic policies within a heterogeneous monetary union <i>Angel Asensio</i>	247

One size fits none? Common monetary policy and inflation differentials in EMU <i>Felix Geiger and Heinz-Peter Spahn</i>	281
--	-----

The ECB – How much of a success story, really? <i>Jörg Bibow</i>	301
---	-----

Perspectives on Economic Policy in the Economic and Monetary Union <i>Philip Arestis and Malcolm Sawyer</i>	331
--	-----

Editors and Authors	353
---------------------------	-----

Introduction

Eckhard Hein, Jan Priewe and Achim Truger

Despite the current growth speed up and increasing employment within the European Union (EU), and above all in Germany, one of the Euro area's former 'sick men', it is still true that European (economic) integration is in crisis. Many countries continue to face major economic problems. Economic performance within the EU and particularly the Euro area has been lagging behind the USA, not to mention other regions of the world. Many of these problems are caused by the restrictive 'Maastricht economic policy regime'. To put it shortly, this regime may be characterised:¹

- by the European Central Bank's (ECB) exclusive focus on price stability and its overly ambitious inflation target,
- by the lack of active fiscal policy imposed by the Stability and Growth Pact (SGP), also in its revised version,
- and by the focus on so-called structural reforms, particularly in the labour market, which – together with high unemployment – continue to undermine the wage bargainers' ability to set wages with an eye on macroeconomic stability.

Above all the latter will exert deflationary pressures on the Euro area as a whole as soon as the next recession materialises. Against the background of this bias towards a restrictive policy mix, EU-enlargement and the inclusion of the Middle and Eastern European countries has considerably increased the degree of nominal and real differences within this economic area. It is not at all clear whether and how the EU will be able to

¹ For a detailed discussion of the problems of the 'Maastricht economic policy regime' see for example Hein/Niechoj (2007) and Hein/Truger (2007a, 2007b).

cope with these differences and the already existing tendencies of divergence among the 'old' member states. These tendencies may not only aggravate the existing economic problems within the EU but they might even endanger the political project of European integration as such.

Therefore the chapters in this book focus on the theoretical, empirical and political aspects of European integration. Among other topics they contain critical analyses of optimum currency area theory and are concerned with the theoretical foundations and empirical consequences of the 'Maastricht regime'. Monetary, fiscal and wage policies and their coordination within a monetary union are analysed. Some country studies complete the picture.

The chapters on 'European integration in crisis' are preceded by **Jürgen Kromphardt's** contribution on the occasion of the 10th anniversary of the Research Network 'Alternative Macroeconomic Policies'. Kromphardt, a former member of the German Council of Economic Experts, discussing the future of macroeconomics in Germany asks: 'Revival or survival of macroeconomic policy analysis in Germany?'. To him, the inclusion of the term 'alternative' in the name of the aforementioned research network suggests that one can distinguish at least two kinds of macroeconomic policies. He argues that this may be held for macroeconomic theories, with one kind based on the Walrasian approach, and the other on Marshall and Keynes. However, only the latter demonstrates the necessity and usefulness of macroeconomic policy. This is why for him there is only one macroeconomic theory and there exists no alternative. The chances that this kind of macroeconomic theory based on Marshall and Keynes will survive at German universities seem to be rather small. Therefore, information about and research on macroeconomic theory should be organised outside these institutions inundated with mainstream teachers. Nevertheless, he sees hopes for a revival of genuine macroeconomic policy, because of the negative experiences with supply-side policies in Germany and successful macroeconomic policies in other countries, especially in the UK and the USA.

In 'Reconsidering the theories of optimum currency area – a critique' **Jan Priewe** reviews the early and later theories of optimum currency area (OCA). He sees a variety of contrasting theories, stipulating either narrow currency areas or very wide ones, especially in many later concepts. Five criticisms are elaborated with regard to the standard theories: (i) Currency 'area' is a vague term which may denote currency coopera-

tion or a full-fledged currency union. (ii) The criterion of a low degree of 'asymmetric' shocks as precondition for a currency area is too narrow, because focuses on demand shocks and neglects supply shocks, particularly those which reflect institutional idiosyncrasies of nation states. (iii) Real convergence as a necessary property of currency unions is underestimated, at least in many concepts. (iv) Not all preconditions for OCAs are endogenous, as it is often asserted. (v) The issue whether or not a monetary union requires a political union – as historical evidence clearly shows – is not addressed seriously. Wide currency 'areas' in the sense of unions which incorporate strong economic and political heterogeneity are likely to lead to divergences amongst the members and to a sub-optimal overall performance.

In the chapter 'Fixed and flexible exchange rates and currency sovereignty' **Claudio Sardonì** and **Randall Wray** provide an analysis of Keynes's original 'Bancor' proposal as well as more recent proposals for fixed exchange rates. They argue that these schemes fail to pay due attention to the importance of capital movements in today's economy, and that they implicitly adopt an unsatisfactory notion of money as a mere medium of exchange. They instead develop an alternative approach to money based on the notion of currency sovereignty. As currency sovereignty implies the ability of a country to implement monetary and fiscal policies independently, it is necessarily contingent on a country's adoption of floating exchange rates. As illustrations of the problems created for domestic policy by the adoption of fixed exchange rates, they briefly look at the recent Argentinian and European experiences and take these as telling examples of the high costs of giving up sovereignty (Argentina and the European countries of the EMU) and the benefits of regaining it (Argentina). A regime of more flexible exchange rates would have likely produced a more viable and dynamic European economic system, one in which each individual country could have adopted and implemented a mix of fiscal and monetary policies more suitable to its specific economic, social, and political context. Alternatively, the Euro area will have to create a fiscal authority on par with that of the U.S. Treasury, which means surrendering national authority to a central government – an unlikely possibility in today's political climate. The authors conclude by pointing out some of the advantages of floating exchange rates, but also stress that such a regime should not be regarded as a sort of panacea.

'Currency unions: some lessons from the Euro zone' is the title of **Charles Goodhart's** contribution. He argues that whilst there were many sizeable benefits from a currency union, the main disadvantage was often the difficulty of adjusting to an asymmetric shock. Such adjustment was easier when the separate countries (regions) in such a union had flexible labour markets, and when there was a federal fiscal system to ease the adjustment process. The Euro area has neither. The author shows that the trends in relative unit labour costs have in several recent cases been worsening relative competitiveness, thereby putting the Euro area under greater centrifugal pressure. Nevertheless he thinks that the costs of 'exit' are so high that it would only probably occur as a consequence of political miscalculation.

In 'Economic divergence in the Euro area – why we should be concerned', **Jan Priewe** analyses economic divergence in the Euro area since 1999 and the mechanisms to cope with it. The divergent economic performance of the member states of the Euro area and the overall weak growth in the period 1999-2005 is reviewed. He identifies mainly the divergent unit labour cost development, inflation differentials causing real interest rate differentials, and divergent current account balances as critical for the functioning of the currency union. To him, self-correcting mechanisms seem to work slowly and they are dampening growth and employment. Early prevention of critical divergent trends is advised. This, however, requires more centralised fiscal policies alongside monetary policy, active coordination of fiscal, monetary and wage policies, and steps towards a political union.

'Wages and regional coherence in the European Monetary Union' is the subject chosen by **Hansjörg Herr** and **Milka Kazandziska**. They argue that the creation of the Euro area marked a structural break for the member countries of the currency union. Monetary policy was transferred to the ECB and even more important, nominal exchange rate adjustments have become no longer possible. However, usually, at least in history, monetary unions and states had been identical. The authors regard the process of creating a European constitution as stuck and state that even if the EU succeeded in ratifying a constitution, it would not be comparable to the constitution of a usual state: The budget of the central level of the EU compared, for example, with the budget of the federal state in the United States, a not very centralised country, is minuscule and has only about the volume of the budget of a larger German regional

state. For example there are no taxes directly levied by the Euro area centre. Tax systems, social security systems, labour market institutions and wage bargaining processes are markedly different in the Euro area countries. Overall, the currency union is seen to be a unique historical experiment with the chance to create a prosperous and politically strong Europe but also with the danger to become a monetary union with deep regional problems, economic stagnation and political instability.

In the first country study of the volume, 'Reforms and Continuity in the Italian economy: EMU at risk?', **Stefano Solari** and **Claus Thomasberger** turn to the question whether the concerns that the Italian economy might cause harm to the Euro area are substantiated. They analyse the extent of divergence among the main Euro area countries and highlight the dynamics which produce such strains. In particular, they question that price and wage flexibility – presupposed in the present policy framework – can effectively correct the imbalances which have emerged. The main findings are that such channels are not working as expected and a self-reinforcing process of divergence is in place, which depends both on the Euro area and national institutional frameworks. Moreover, German policies aimed at increasing competitiveness by controlling wages are exporting tensions to its trade partners in the Euro area.

Jesús Ferreira, **Carmen Gómez** and **Felipe Serrano** present the second country study 'How much room for expansionary economic policies in the EMU? The case of Spain'. They claim that the current expansion of the Spanish economy was a good proof of the validity of Keynesian economic recipes. To them, the positive performance in terms of GDP growth and employment creation in Spain can be explained by a policy mix consisting of: an expansionary monetary policy, a neutral or slightly tight fiscal policy and a moderate wage policy. Low, even negative, real interest rates were fuelling consumption and investment. High economic growth was generating a significant surplus in the public budget, which, in turn, was partially slowing down economic growth through the operation of built-in stabilizers. Finally, the wage moderation operating since 1997 has been contributing to an acceleration of the employment creation process and, consequently, to a reduction of the unemployment rates. However, this Keynesian-expansionary macroeconomic policy was not working in a discretionary way. High inflation rates were the element that made expansive (monetary) policy initially designed as restrictive or, at best, neutral.

'Can the European construction really continue relying on the NAIRU?' is the question asked by **Dany Lang**. He argues that since the beginning of the 1990's, the 'Non Accelerating Inflation Rate of Unemployment' (NAIRU) has been one of the most important concepts on which the economic design of Europe relies. If such a NAIRU exists, and if the unemployment rate comes close to it, unemployment can only be reduced through supply-side oriented policies, in particular labour market reforms. These views can be found in many documents edited by the European Commission and are expressed in the so-called 'Growth and Stability Pact' and the 'Lisbon Strategy'. The NAIRU also implies that the fight against inflation constitutes the most important economic policy goal for monetary policy, which is clearly the case at a European level. However, according to the author, the NAIRU has always raised numerous grave theoretical and empirical issues. In light of these issues, the proponents of the NAIRU have begun to amend their models and to deal with these concerns. The most important results of this research process are the time-varying NAIRU and the new NAIRU models based on the so-called 'New Keynesian Phillips Curve'. The contribution first examines the 'old-fashioned' NAIRU models in order to recall their principal limitations. Then it investigates the most recent developments in the NAIRU literature to determine whether the theoretical and empirical changes imposed on the NAIRU concept have resolved the main flaws of the original concept.

In his contribution on 'Co-ordinating macroeconomic policies within a heterogeneous monetary union' **Angel Asensio** focuses on monetary-fiscal interactions within a two-country monetary union. He states that it is especially in the face of strong inherited unemployment that the central banks' and governments' responses are potentially more conflicting. Strong inherited unemployment can therefore be one of the obstacles to macroeconomic policy success in the Euro area. Moreover, heterogeneity is likely to enforce adverse interactions and to make the policy mix less efficient. The central bank profile, however, determines the sign and magnitude of the monetary and fiscal instrument responses. Since the weaker the required responses are, the more ambitious the targets can be, the central bank profile proves to be a key parameter. Therefore, provided institutions are made able to control the distributive conflict, adverse interactions can be avoided if the monetary policy specialises in countering the common effects of shocks (including inherited unem-

ployment), whereas governments concentrate on countering the idiosyncratic effects. Employment targets then require lower instrument responses, as a result of efficiency gains.

Felix Geiger and **Peter Spahn** turn to monetary policy in 'One size fits none? Common monetary policy and inflation differentials in EMU'. They argue that nominal divergence in Euro area can be explained by the dominance of the real-interest effect over the real-exchange-rate effect. Their chapter contributes, first, to the analytical debate on the macroeconomic sources of divergence. If national wage setters use domestic inflation instead of the ECB's inflation target when forming inflation expectations, and if national business cycles exhibit high persistence, the probability of convergence is low. Second, on an empirical level, EMU countries with a trade deficit are to be distinguished according to their overall macro performance: in high-employment countries the trade deficit helped to curb inflation, in low-employment countries fiscal policy was trapped in the conflict of serving external or internal equilibrium. The Euro area had abolished a balance-of-payment channel of stabilisation, working, besides the competitiveness channel, via the interest rate. To restore this effect of monetary policy, the ECB might impose higher repo rates on securities of high-inflation countries, the authors suggest.

In the second chapter on monetary policy, 'The ECB - How much of a success story, really?', **Jörg Bibow** assesses the ECB's performance since 1999. The analysis begins with a brief summary of the Maastricht regime, highlighting its key flaws and the ECB's centre position within it. The ECB's performance is then investigated in line with the three broad cyclical phases observed in the bank's monetary domain since 1999, namely: the brief upswing of 1999-2000, the drawn-out stagnation of 2001-05, and the belated and export-driven 'goldlocks recovery' of 2006-07. The key finding is that not only has the ECB played a pivotal role in Euroland's uninspiring economic performance. Also today the ECB seems to be running the risk of repeating its earlier blunders, particularly that of pre-emptively cutting short a recovery for which it has done far too little to get off the ground in the first place.

Last, but not least **Philip Arestis** and **Malcolm Sawyer** conclude the volume with their 'Perspectives on economic policy in the Economic and Monetary Union'. In their eyes the achievement of full employment and other relevant objectives requires the use of macroeconomic policy to secure high levels of aggregate demand and the building of adequate pro-

ductive capacity. The alternative view, which underpins the approach of the institutions of the Economic and Monetary Union, is that unemployment was a result of 'inflexible' labour markets, and hence the promotion of 'flexible' labour market policies will bring full employment. The authors argue, though, that whether or not labour markets are 'flexible' is largely irrelevant where full employment is concerned, which requires high levels of demand and of productive capacity. Thus, a reorientation of macroeconomic policy is necessary for the achievement of the major objectives of full employment and sustainable growth. Monetary, fiscal and exchange rate policy have a full role to play in the pursuit of those objectives, according to the authors.

The papers in this volume were presented at the 10th conference of the Research Network 'Alternative Macroeconomic Policies'. The conference took place in Berlin, 27-28 October 2006. Further papers from the conference will be published in a special issue of INTERVENTION, Journal of Economics. We would like to thank the contributors to this volume for their cooperation and the participants in the conference for the stimulating discussions. Special thanks go to Barbara Schieders for the assistance in the editing process and to the Hans Boeckler Foundation for organisational and financial support for both the conference and the publications. On the special occasion of the 10th anniversary workshop we would particularly like to thank the Hans Boeckler Foundation for the support of the activities of the Research Network during the last decade.

References

- Hein, E., Niechoj, T. (2007): Guidelines for sustained growth in the EU? The concept and the consequences of the Broad Economic Policy Guidelines, in: McCombie, J., Rodriguez, C. (eds.), *The European Union. Current Problems and Prospects*, Basingstoke: Palgrave Macmillan.
- Hein, E., Truger, A. (2007a): Monetary policy, macroeconomic policy mix and economic performance in the Euro area, in: Hein, E., Truger, A. (eds.), *Money, Distribution and Economic Policy. Alternatives to Orthodox Macroeconomics*, Cheltenham: Edward Elgar.
- Hein, E., Truger, A. (2007b): Fiscal policy and macroeconomic performance in the EMU – lessons for the future, in: Bitow, J., Terzi, A. (eds.), *Euroland and the World Economy. Global Player or Global Drag?*, Basingstoke: Palgrave Macmillan, forthcoming.

Revival or survival of macroeconomic policy analysis in Germany?

Jürgen Kromphardt

1. Congratulation to the Research Network 'Alternative Macroeconomic Policies'

I am grateful for the invitation to speak here on the occasion of the 10th workshop of the Research Network 'Alternative Macroeconomic Policies'. I was invited as someone who has not, or not yet, cooperated closely within this network, but who is expected to be favourable to its activities. Since I am strongly impressed by the output of the research network, it is a pleasure for me to congratulate the whole network on its persistent success. The network has worked continuously and each year it has published an interesting, instructive and valuable volume assembling the contributions of the conference held the year before.

Nine volumes have already appeared; they have covered the most important aspects of macroeconomic theory and policies. The first one was given a rather optimistic title, namely 'Renaissance der Makroökonomik' (Renaissance of Macroeconomics) without question mark. Already the second volume and also the last one were concerned with the problems of macroeconomic policy in Europe, on the national and/or the European level. Monetary and fiscal policies were addressed in two separate volumes. Another one was concerned with the question whether, and how, a new international monetary order should be established. 'The USA as a model of the New Economy?', the 'New Keynesian Economics' and the macroeconomic analysis of 'Wages, employment, distribution and growth' were the topics of the remaining three volumes.