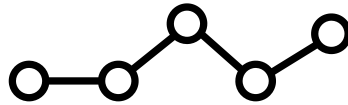

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POLICY BRIEF
8

Internal and external rebalancing for Euro area members

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

The aim of this brief is to elaborate an argument in favor of a stabilization fund, financed by a flexible mix of VAT and payroll taxes, that can perform the role of an adjustment mechanism.

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

The second part presents two episodes relating to currency realignment, i.e. the mechanism that existed in the smaller European Union during the European Exchange Rate Mechanism (ERM). These episodes show that imbalances were difficult to resolve even when EU members maintained their own currency.

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

The necessary conditions for functioning currency area

Relative prices adjustment

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

Two countries that trade goods and assets need a mechanism that allows relative prices and wages to change for them to be able to achieve both internal and external balance. While there is little or no disagreement on this necessary condition, there are different opinions as to the effectiveness of the mechanisms to achieve changes in relative prices and wages.

As an example, assume that the Italy is running a trade deficit vis-à-vis Germany. To regain competitiveness and a balanced external position, the hourly wage in Italy must decrease relative to the hourly wage in Germany. In the presence of national currencies, the nominal exchange rate is the price that permits to the relative prices to change instantaneously: the nominal value of the Italian currency decrease relative to the German currency, which implies that the nominal hourly wage in Italy decreases relative to the German hourly wage.

When there is no exchange rate one needs an alternative mechanism. Some view market mechanisms as sufficiently rapid and strong to achieve adjustments through wages and prices changes. For example, a former member of the European Central Bank (ECB) board, in explaining the "Economic adjustment in a monetary union" (2011), writes:

"...Therefore, the key adjustment mechanism in a monetary union is price and wage flexibility, assuming that cross-border labor mobility is limited...(...)... In fact, wages and prices are, by definition, the only remaining component of the real exchange rate that can be adjusted in the absence of nominal exchange rate flexibility."

The problem with this view is that the facts point to a strong downward nominal wage rigidity (see for example the evidence reported by the *Wage Dynamics Network of the ECB* and national central banks), with the implication that the adjustment results in higher unemployment and lower consumption. The lower consumption reduces imports and that helps reaching external balance but at the cost of larger internal imbalance, Mundell (1961) identified labor mobility as an alternative mechanism to wage and price adjustment. In short, emigration from the country that need to restore internal balance would help to achieve full employment by shrinking the labor force.

Farhi and Werning (2014) shows that Mundell's mechanism is not so straightforward because emigrants are not just workers but also consumers: emigration reduces the labor supply but also the demand for goods. They show that the net effect of emigration is positive if the degree of openness and trade integration is high, a metric that was identified by McKinnon (1963) as another condition for two countries to share the same currency. Furthermore, emigrants are also taxpayers, human capital, etc., adding layers of complexity to the net effect of migration as an adjustment mechanism.

Fiscal integration

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

A second condition, made popular by Kenen (1969) is the level of fiscal integration between countries that share the same currency. The key point is that an integrated fiscal policy implies the existence of automatic stabilizers such as a common unemployment insurance that transfer resources from countries that are in a boom, and therefore have low unemployment, to countries that are in a recession and therefore have high unemployment. Integrated fiscal mechanisms help to achieve internal balance.

There is disagreement on the desirability of this condition. For example, there is a view that fiscal transfers might help to achieve internal balance but in an artificial way, as they do not permit the adjustment in relative prices to occur.

The statement of the same member of the board of the ECB (2011) summarizes this view:

"Open-ended transfers, however, are not a mode of adjustment. In fact, they are the opposite. They finance non-adjustment."

The mechanism proposed in this brief aims to point the relative adjustment in the presence of fiscal transfers.

Trade and financial openness have actually long implied misalignments between different fiscal and monetary jurisdictions, with different monetary and trade arrangements. This leads to the second part of this brief, which shows two episodes of currency realignment during the ERM. The aim is to recall that adjustment difficulties were not particularly less intense in fairly recent times in which these countries still had their own currencies.

Fiscal integration and other conditions

Current discussions on euro area architecture reform focus more on financial integration. For example, Eichengreen and Wyplosz (2016) identify the completion of Europe's banking union as one of four minimal conditions for the euro area to continue to exist in the near future. With a full banking union, financial markets can achieve a better and more efficient allocation of resources and provide a smoother financing of the external imbalances between countries.

Other reform options have been put forward, such as i) improving capital markets integration across Eurozone members to achieve better risk sharing or ii) the necessity for the ECB to definitely include the role of lender of last resort in order to backstop sovereign bond markets, thereby protecting the euro area from self-fulfilling crises (De Grauwe, 2011).

In fact, if all the conditions required for a functioning currency area are listed (see e.g. Stiglitz, 2016), one could easily conclude that the single currency might not be the best monetary arrangement for European countries – I do not subscribe to this view.

Realignments in the ERM

Before the introduction of the Euro, exchange rates were managed according to a system called the ERM (European Exchange Rate Mechanism). A grid of bilateral rates was calculated based on central rates expressed in European Currency Units (ECU), and currency fluctuations had to be contained within a margin of 2.25% either side of the bilateral rates – except for the Italian lira and a few others, which were allowed a margin of 6%.

The structure of the bilateral central rates was to be agreed unanimously by the Ecofin Council, composed of the Finance Ministers and Governors of the Central Banks of the participating countries. The bilateral central rates were aligned 11 times between 1979 and 1987, once in 1990 and 5 times between 1992 and 1993. The last realignment was in 1995.

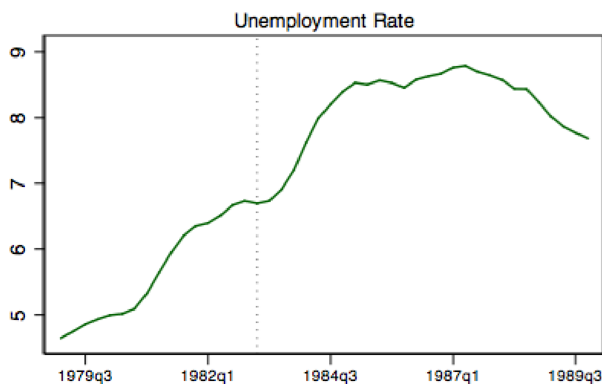
In this not too distant past, realignments between European countries required everybody's agreement. The 13 years of ERM before the crisis had pushed members to develop effective procedures to coordinate the setting of exchange rate parities which, in the best European tradition, required unanimous approval.

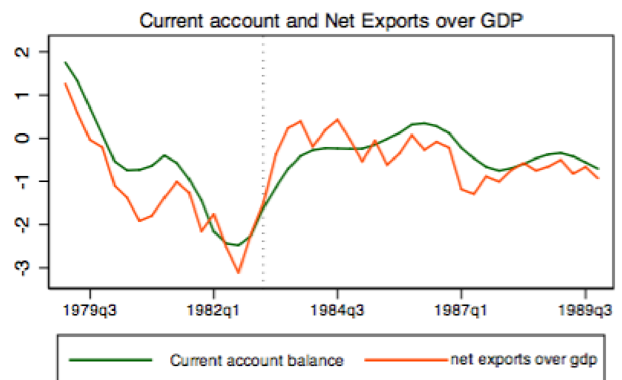
France, 1983

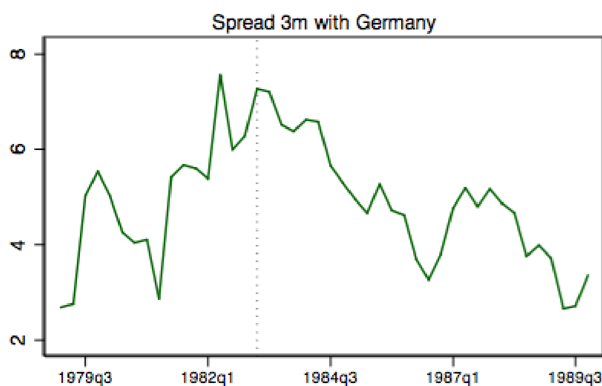
"Eight European nations agreed today to realign their currencies after West Germany accepted French demands and agreed to a set of currency values that avoided the possible collapse of the European Monetary System (...) German officials said Mr. Delors had given assurances that France would reduce its budget deficit by cutting spending on social programs and welfare payments. Mr. Delors also reportedly said that France would try to reduce the deficits of its nationalized industries, another cause of inflation. The devaluation itself would cut the trade deficit by making imports more expensive and exports less costly to others."
New York Times, 21st March 1983

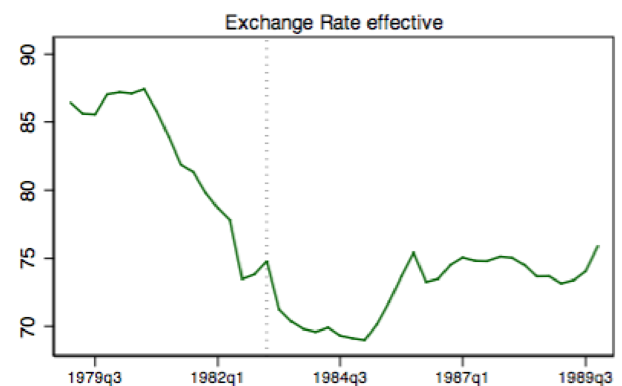
This was the case for the episode reported by the *New York Times*. At the time, France was experiencing a process of internal devaluation (lower wages and prices through higher unemployment) that had been accompanied by three previous realignments between the Franc and the German Mark in order to face an increasing external imbalance. Ultimately France was able to restore competitiveness and close the trade deficit, but at the cost of higher unemployment, even with the devaluation of the Franc.

France 1983









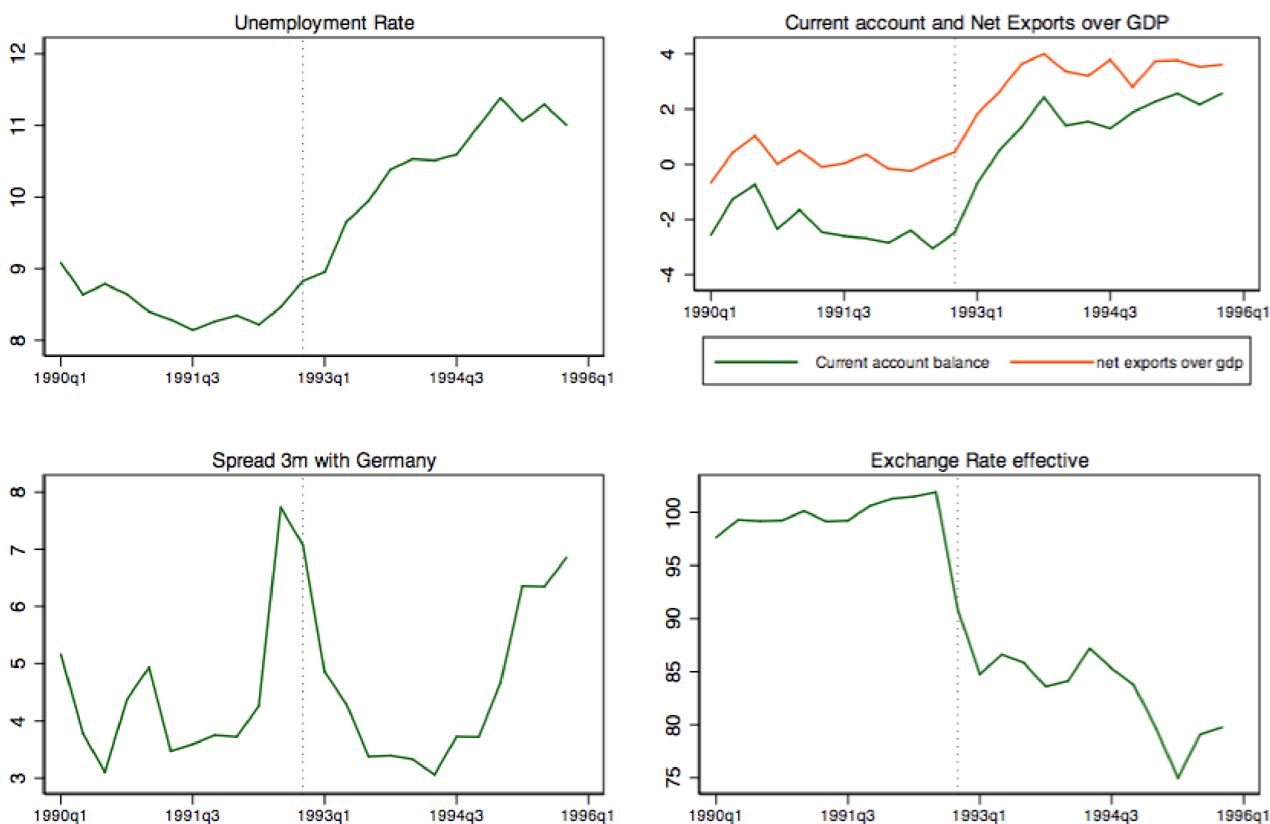
Source: OECD 2016, quarterly data. dotted line corresponds to quarter of NYT artile.

Italy, 1992

In 1992, an agreement on realignment was not reached and this caused Italy to exit the ERM. At the time, i) countries had experienced different paths in unit labor costs (divergence), ii) there had been a (very) large asymmetric shock (Germany reunification), iii) the European political project was perceived to be weaker (French and Danish referenda), and iv) European leaders seemed unable to coordinate (Bath summit).

Unfortunately, the "un pour tous, tous pour un" approach is meant to be self-supportive for a group that stays loyal to each other through thick and thin. This is not the best description of European leaders during the ERM crisis, when realignment became "a dirty word in Bath" (see Buiter and al. 1998). In the absence of consensus, Italy and Germany had to bilaterally propose that the Lira would devalue by 3.5% and the Mark revalue by 3.5% against all currencies in the ERM. Some members refused.

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



Source: OECD 2016, quarterly data. dotted line corresponds Italy Exit.

A stabilization mechanism

Fiscal devaluations

A basic source of criticism against the Euro is that devaluations and revaluations across member countries are not possible anymore. While the examples above show that national currency realignments were by no means a panacea, it is true that the euro area needs mechanisms to emulate the effects of devaluation, and help in the adjustment of external imbalances.

A possibility is to use neutral tax swaps. In Franco (2011), I looked into the effects of “fiscal devaluation”, namely, a decrease in labor taxes balanced by an increase in consumption taxes (see Farhi et al., 2014 for a more complete treatment). It is not a perfect substitute for nominal devaluation: it has advantages, such as the absence of adverse effects from the relatively increased costs of servicing foreign denominated debt, and has disadvantages, such as imperfect pass-through and the legal and political difficulties to implement it, compared to a currency devaluation. Nevertheless, it is a fiscal mecha-nism that aims at reducing external imbalances across the currency area countries by allowing relative prices to change. This solution was, at a certain stage, widely discussed in political circles (European Commission, 2014).

Unemployment insurance

Mechanisms to increase fiscal integration in the EU or the Eurozone are currently the subject of active research. These would allow for implicit or explicit temporary fiscal transfers with a macroeconomic risk sharing rationale, i.e. to smooth the impact of asymmetric external shocks in member countries and thus diminish possible external imbalances at the source, by helping countries to maintain internal balance across the currency area.

Popular variants that have been suggested include a common European unemployment insurance scheme (for a summary of the discussion, see Pereira et al. 2017) to complement national systems or a simpler stabilization fund. The advantages of such mechanisms from a macroeconomic perspective are clear, but go beyond basic mechanics. For example, it has been noted that the fact budget deficits are constrained by European rules, might force countries’ discretionary fiscal policy stance to become pro-cyclical during a downturn, especially in the case of countries with already high levels of public debt (and therefore less “fiscal space”). Adjustment mechanisms such as those currently in discussion would allow automatic stabilizers to work with a smaller impact on national fiscal deficits.

There are also disadvantages. For example, fiscal transfers could slow down the adjustment of relative prices and impair the adjustment of external imbalances, as referred in the section regarding the necessary conditions for a functioning currency area. There are also concerns of a microeconomic nature, such as moral hazard issues in designing national unemployment benefits legislation; especially given the high heterogeneity, in terms of design and generosity levels, of the national systems already in place.

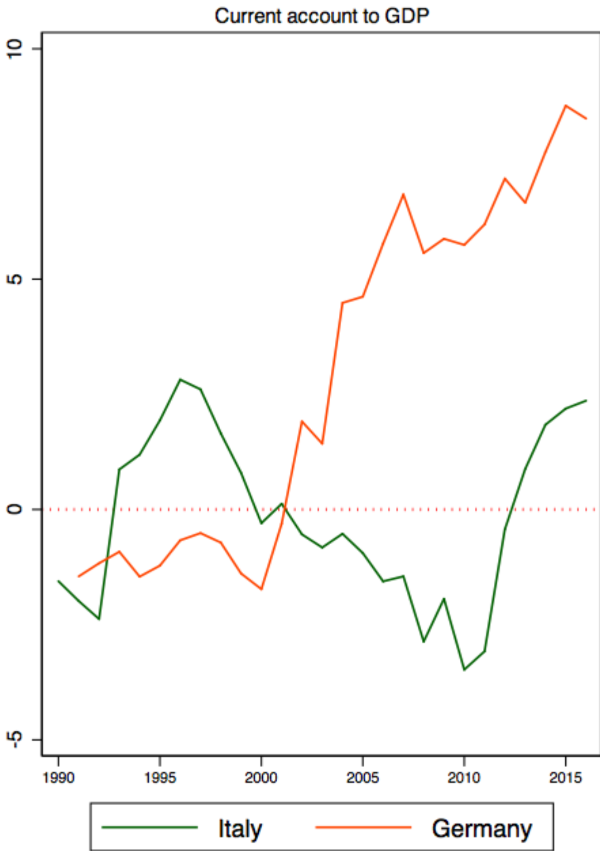
Nesting unemployment insurance with fiscal devaluations

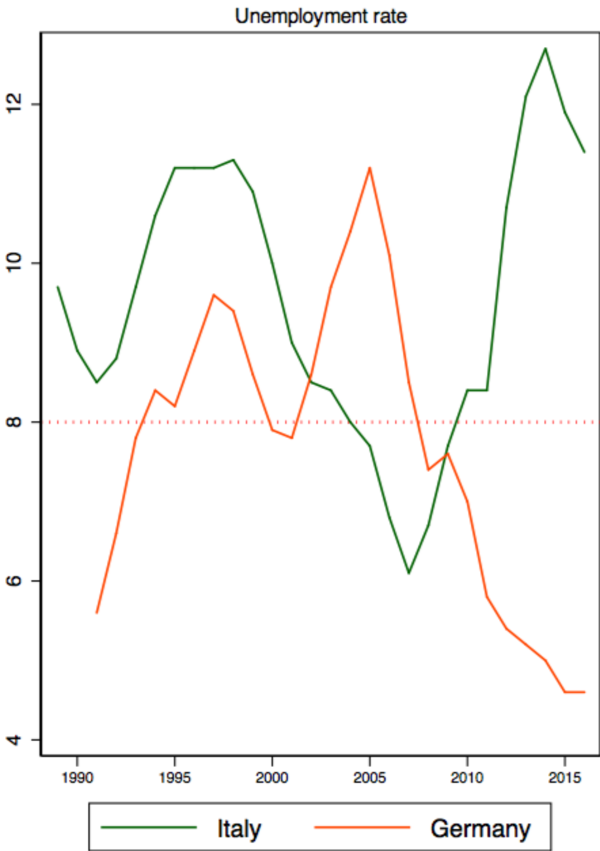
I argue that a hybrid strategy should be given consideration. Namely, nesting an unemployment insurance (UI) mechanism financed through a flexible fiscal policy mix that can mimic realignments through fiscal devaluations (FD). The unemployment insurance could be a simple insurance mechanism and would play the role of an automatic stabilizer for the internal balance. This would be financed through a mix of VAT and payroll taxes.

The financing mix should change symmetrically across surplus and deficit countries to help the external balance adjustment and allow relative prices to change in the right direction. The key condition, namely the existence of time varying asymmetry in external and internal positions across the euro area countries, is thus fulfilled.

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

We can anticipate that the necessary conditions to not have constant transfers is that the nation systems must be financially sustainable in the long term.





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

Conclusions

This paper focuses on macroeconomic adjustments within the euro area and not on possible long run trend differences in competitiveness that require microeconomic and structural policies. The latter are, of course, important but so are the imbalances. Furthermore, there is increasing evidence that macroeconomic imbalances might have consequences that are extremely persistent if not permanent (Blanchard and Summers, 2015). The main point is that the Euro area needs policy instruments that permit internal and external rebalancing and, at the same time, are coherent with the degree of national sovereignty.

Recent experience has shown that internal devaluation is not a sufficient mechanism to this end. Euro member states could initially agree on a relatively small stabilization fund to be financed through a flexible mix of VAT and payroll taxes. The payments from the fund to member countries would be done according to the internal balance and the member countries tax-mix that finances the fund would change symmetrically according to the external position. The mechanism could be tested and scaled up later if successful. Ultimately, we all need to agree that these imbalances do matter.

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