Europe's Gamble. Comments and Discussion

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Comments and Discussion

Alberto Alesina: This is an excellent and very exhaustive paper, and I very much agree with its message. European monetary union is a gamble. In fact, I am more pessimistic than Maurice Obstfeld: in my opinion, it is a gamble that should not be taken. In this comment, I address a few points already touched on in the paper and make some additional observations.

IS EUROPE OF THE OPTIMAL SIZE FOR A COUNTRY? Probably not. ''Europe'' (meaning the potential members of EMU) will never be a nation state, but it may come close to being a federal nation state. Many argue (correctly) that some form of political union is necessary for monetary union to be sustainable. Others take the even stronger line that monetary union is merely a step toward the real goal of European political union. I would argue that this is contrary to history. In 1946 there were 74 countries in the world and today there are 192. More than half of these countries are smaller than Massachusetts. In 1995, 87 countries had fewer than 5 million inhabitants.

One can think of the equilibrium size of a country as the result of a trade-off. On the one hand, small countries have the benefits of a low degree of conflict and relative convergence of preferences. On the other hand, large countries have several advantages, including economies of scale in the provision of public goods, insurance against shocks, and market size. However, as world trade becomes more open, one of the main benefits of a large country becomes much less important. A country does not have to be big to be open. Thus the tendency toward a reduction in average country size is perfectly understandable in an

environment of trade liberalization. Why would a country want to lock itself in a political union when it could be small, enjoy freedom of political choice, and trade peacefully with the rest of the world? There is no need for political integration when there is economic integration. Indeed, as I argue elsewhere with Enrico Spolaore and Romain Wacziarg, economic integration should go hand in hand with political separatism.[1] Europe is going in exactly the opposite direction.

IS EUROPE AN OPTIMAL CURRENCY AREA? Almost certainly not. Obstfeld deals extensively with this point in the paper. My reading of the evidence is that the pure economic benefits of a European monetary union are probably fairly small and the costs—which are very hard to measure—could be quite large. This in the sense in which I think it is not a gamble worth taking. The benefits of monetary union are well known: smaller transaction costs, less exchange rate volatility, greater credibility. The paper argues that for a variety of reasons, these benefits, except perhaps the last, are not very large. Nevertheless, Obstfeld notes that the asymmetry of economic shocks in Europe is a source of concern. It is possible, however, that the countries with the most asymmetric shocks are also those with the most to gain in terms of credibility in monetary policy. This is a point worth investigating.[2]

The paper also correctly emphasizes the role of labor mobility in a monetary union. As is well known, labor is not very mobile in Europe. Blanchard and Lawrence Katz show that labor mobility within each country in Europe is lower than that within the United States.[3] Labor mobility across European countries is even lower. It should be recognized that labor mobility may have high utility costs in Europe, although these never enter into standard cost-benefit analyses. That labor mobility within a currency area that includes very strong cultural and linguistic differences is costly, relates to my point that the optimal size of countries is a function of cultural homogeneity.

I would like to clarify one of the few issues that Obstfeld leaves unclear: what is the alternative to monetary union? The paper seems to predict that if monetary union does not materialize, Europe will go back to a system of fixed adjustable exchange rates, which most likely will require restrictions on capital mobility. This would be a worse scenario

1. Alesina, Spolaore, and Wacziarg (1997).
2. For some evidence on this point, see Alesina and Grilli (1992).
3. Blanchard and Katz (1992).

than either monetary union or flexible rates. Thus in my opinion, the only reasonable long-run alternative to monetary union is flexible exchange rates, with free mobility of goods and factors of production.

IS EMU USEFUL FOR ENFORCING CONVERGENCE CRITERIA? First, suppose that EMU is a bad idea because of the structural arguments discussed above, which boil down to the fact Europe is not an optimal currency area. This proposition implies that it is good to adopt the wrong monetary system (perhaps for generations to come) simply in order to help a few countries to reduce inflation and budget deficits at one particular point in time. This strikes me as a major overvaluation of short-term gains relative to long-run costs. Either EMU is a good idea as a monetary system or it is not; convergence criteria are means, not goals.

Second, the convergence criteria for fiscal policy, which have proven to be the most challenging and controversial, have had both positive and negative effects. They probably have created incentives for some countries to reduce deficits more quickly that they would otherwise have done. However, the fiscal criteria overemphasize deficit reduction measures and do not pay enough attention to levels of spending and taxation. As a result, too much of the adjustment has been on the revenue side. For many countries in continental Europe, the real problem is not overly large budget deficits, but an excessively burdensome welfare state that requires very high taxes. Moreover, one must ask whether these convergence criteria are necessary for monetary union.

Third, it is possible that most countries would have adjusted without EMU. There are two pieces of evidence in favor of this view. When inflation was brought down sharply in the EMS countries, in the early and mid-1980s, inflation was coming down throughout the OECD. The countries in the EMS did no better than those that were not. And many other countries around the world have adjusted their fiscal balances during the past decade. While I do not deny that the progress of monetary unification and the Maastricht agreement may have helped European countries to adjust, it is not at all clear how much they have done so.

IS EMU USEFUL FOR ENFORCING PEACE IN EUROPE? It is often said, both by the press and in academia, that the economic costs and benefits of EMU are trivial compared with the true political advantage of European union: that it would prevent disruptive military conflicts such as those

that led to the two world wars. I find this argument unconvincing, and possibly wrong. One could argue that the likelihood of escalating conflicts might actually increase if several countries are forced to coordinate policies and compromise on various issues for the sake of an unnecessary monetary union. A system of free trade accompanied by national independence in the choice of policy may be best suited to promote peaceful interactions. At the very least, this reasoning is as convincing as the opposite. I would also note that over the past twenty years, animosity amongst western European countries has rarely been as high as in recent months, when monetary union is becoming a reality.

Finally, I come to my only nontrivial disagreement with the paper. Obstfeld points out that Europe's biggest problem is the lack of labor flexibility, and that the introduction of EMU might help in this respect. The reasoning—which is not fully spelled out in the paper—is that labor unions will accept more labor flexibility to compensate for the fact that the exchange rate can no longer serve as a channel for adjustment. That is a reasonable, but slightly optimistic, view. Another possibility is that labor unions will react strongly against the monetary rigidity imposed by monetary union, without yielding on labor flexibility. This could aggravate social tensions and increase political conflict, both within and across countries, leading some countries to leave the monetary union. Such an event would have very serious consequences for the credibility not only of the countries that leave, but of the entire project.

I would note that in the recent progress toward European unification, voters have often been less enthusiastic than their politicians. This observation raises some doubts about the political sustainability of the process and indicates that, in this case, the citizens of Europe have been more prudent than their leaders.

Richard N. Cooper: This is an admirable paper. It is comprehensive, thoughtful, and judicious. I agree with much of it. However, as a whole, it leaves me slightly uncomfortable. Without precisely saying so, Obstfeld gives the impression that currency union in Europe is a bad idea; but that if EMU is going ahead, as it is likely to, the Maastricht treaty—in particular, its fiscal provisions— is, on balance, beneficial. I believe, in contrast, that the objective of monetary union in Europe is a good idea; but that as an instrument to achieve that objective, the Maastricht

treaty—at least, its monetary and fiscal provisions (some parts of the treaty do not concern EMU)—is fundamentally misguided.

With respect to the objective of monetary union, I would start with the observation that the economics profession typically relies on an extraordinarily primitive theory of money. The classic dichotomy between real and nominal variables has served us well both analytically and in the classroom. But if we assume that our theory of money seriously reflects the real world, we risk getting things fundamentally wrong. Many economists believe that. For instance, Obstfeld writes: "The most striking contribution of the monetary unification process to economic efficiency is, perhaps, to have forced inflation into remission in a large number of European countries that seemed locked in its grip at the start of the 1980s." There is neither theoretical nor empirical support for that statement. One is not talking about Argentina, or Brazil, or Turkey, but about having reduced European inflation rates from 7 or 4 percent to 2 percent. Where does the idea of big increases in economic efficiency come from?

And yet, Obstfeld may be correct. Many economists have an uneasiness about inflation—even expected inflation—that simply is not supported by standard monetary theories or empirical evidence. I suspect that this uneasiness arises from the feared loss of efficiency in the transmission of information in a complex economy when the price level is rising persistently.

However, the uneasiness about inflation ought also to apply to flexible exchange rates between countries that are closely integrated economically—they stand or fall together. There is an important piece missing in economic argumentation on the costs associated with fixing exchange rates, such as in Obstfeld's paper, the same missing piece that accounts for the discrepancy between economists' theories and their feelings about inflation. In European economies, tradable goods and services account for over half of consumer spending and even more of business spending. The informational costs of fluctuating exchange rates may be greater than those of inflation. In addition to causing difficult-to-interpret variations in the prices of individual goods, due to differing short-run markup practices, they also result in movements between the prices of tradables as a group and nontradables as a group.

Incidentally, the conventional line of reasoning suggests that one should seriously consider breaking up the monetary union of the United

States. It is not obvious that the fifty states make an optimal currency area. There are some examples, such as Texas in the early 1980s and New England in the late 1980s, of circumstances in which flexible exchange rates would have had desirable macroeconomic regional effects. But I do not observe economists seriously proposing such a plan.

Is Europe an optimal currency area? Almost certainly not. But on some dimensions, it may not be as far away as Obstfeld suggests. Take, for example, the pattern of shocks discussed in the paper. I would conjecture that among these European countries, most of the asymmetric shocks are monetary in origin, either directly or indirectly. If their monetary independence is eliminated, that source of shock disappears. Most of these countries are highly diversified in production and trade, so industry-specific shocks should be well distributed, both between and within countries, and should not be a major source of asymmetric shock at the macroeconomic level. Finland is a possible exception, given its heavy dependence on forestry products, and therefore, on economic grounds, it perhaps should not hasten to join the monetary union.

Much has been made of the low level of labor mobility in Europe. The actual movement of labor within European countries—Germany is the example given in the paper—has been quite low. I would like to make two observations. First, one should not confuse movement with mobility. Mobility in Germany has not been tested because the pattern of national wage-setting has left workers with little incentive to move. Unemployment benefits are high, and significant regional wage differentials are not allowed (even the former East Germany after unification was targeted to reach west German wages within a few years, despite its much lower productivity). So, while one observes little movement, mobility is an unknown factor.

Potential mobility is much higher than Obstfeld suggests, mainly because of the large number of foreign workers in Europe. Seven percent of the German population is foreign, not counting the Bosnian refugees of the past few years; the percentage of the labor force must be still higher. These are Turks, Yugoslavs, Greeks, Portuguese. They do not have deep cultural roots in the places where they are working, so they may be willing to move not only within but also between countries, if they are given adequate financial incentive to do so. It is usually the margin that counts. To have 10 percent of the labor force

mobile may be sufficient to handle the asymmetric shocks that are likely to take place within a European currency union.

In regard to the Maastricht treaty as the instrument with which to achieve European monetary union, my main objection has to do with democratic theory—specifically, the lack of accountability of the proposed Governing Council of the European Central Bank. Both the Federal Reserve and the Bundesbank are meaningfully independent central banks, but both are part of a broader political process, accountable to the legislature. The Maastricht treaty takes the Governing Council, whose decisions will affect millions of people, out of the political process altogether. I view that as a scandalous dereliction, greatly widening the democratic gap in the European Union.

With respect to the fiscal criteria of the Maastricht treaty, I forecast in January 1992—the month after the treaty was agreed and before it was actually signed—that if Europe took the fiscal criteria seriously, it would condemn itself to a decade of economic stagnation. Half of that decade has now gone by and, unhappily, my forecast has so far proved correct. To tie fiscal policy down removes one of a region's major defenses against asymmetrical shocks, namely, regionally adaptive fiscal policy. In moving to currency union, Europeans are necessarily tying their hands regionally on monetary policy. Through the Maastricht treaty, and even more so with the subsequently agreed Stability Pact, they are tying their hands regionally also on fiscal policy. This seems to me to be a mistake of the first order.

Obstfeld, by contrast, sees some merit in the tight fiscal criteria. I want to take up the four arguments that he puts forward concerning the threats to the European Union of excessive fiscal deficits. None of them, he recognizes, is compelling by itself, so one must come to a judgment about their collective merit.

First, Obstfeld suggests that heavily indebted countries might lobby for surprise inflation to reduce their real debts. This idea is, I think, an economist's plaything. My knowledge is not comprehensive, but I do not know of any government that has deliberately engineered high inflation in order to reduce the real value of outstanding debt. That has frequently been the consequence of high inflation, but the inflation itself has usually been associated with some external shock that was not handled well or an internal policy failure involving conflict over taxes or expenditures, not a deliberate decision to generate surprise inflation.

Second, Obstfeld argues that "other potential coordination failures in EMU could be mitigated by fiscal constraints . . . . In a floating rate system, countries might be deterred from fiscal expansion by the fear of appreciating their currencies and squeezing the tradables sector." Although any economist who has studied the Mundell-Fleming model understands this proposition—and there actually have been two important examples, the United States in the early 1980s and Germany in the early 1990s—most "markets" (that is, practical people and officials) believe that excessive budget deficits lead to currency *depreciation*. I accept the Mundell-Fleming result under certain conditions, but Obstfeld is making a point about public perceptions and political reactions. At least to date, the political perception is that fiscal expansion leads to currency depreciation, not currency appreciation, and therefore the argument cannot apply.

Third, Obstfeld suggests that curbing national fiscal discretion might reduce idiosyncratic national fiscal shocks, mentioning three examples: the Johnson fiscal expansion of 1966–67, German unification in 1990, and the Reagan fiscal expansion of 1981–83. Play the thought experiment: would a stability pact have prevented any of these fiscal events? I think not.

The Reagan administration came in with a theory that it could reduce taxes substantially without increasing the deficit. Nothing in the Maastricht rules would have dissuaded the supply-siders from trying to carry their theories into practice. I also doubt that these rules would have prevented President Johnson from making the defense expenditures that he thought necessary to prosecute the war in Vietnam, or Chancellor Kohl from taking what, at the time, was seen as the political opportunity of the century to attain the long-standing national objective of German unification. So, while I do not deny the general point, I think that the chosen examples, the standard cases of major fiscal malfeasance in big countries in recent decades, are misplaced in this context.

Fourth, Obstfeld suggests that fiscal constraints might have the beneficial effect of forcing countries to scale back overgenerous social benefit programs. The examples to date, unhappily perhaps, do not give any support to this proposition. The difficulties faced in the United States in scaling back benefit programs are well known. To reduce the budget deficit, the United States has so far raised taxes and mainly squeezed traditional government, not social transfers. France and Bel-

gium have primarily increased taxes. The only country in which one can see even a glimmer of evidence of this proposition is the Netherlands, and there only a nibble, not a serious bite, has been taken out of social expenditures. Social benefits tend to be protected; either taxes go up, or other government consumption and investment expenditures are reduced, or both.

So, I find all four arguments for treaty-mandated fiscal restraint unpersuasive. In the context of monetary union, where the central bank should not be required to finance budget deficits (thus forcing deficit financing onto the capital market), the Stability Pact is a major mistake.

Finally, a subtheme runs through Obstfeld's discussion of fiscal policy, in essence suggesting that governments are incompetent. But if one is confident that governments are incompetent at management, what makes one think that they are competent at making rules? There are some game-theoretic arguments for making the distinction, but I would venture the view that the discussion to date has focused on only one subset of possible models, emphasizing current decisions. There is another subset of "games" that focuses on the rule-making functions of government, and I conjecture that those would also find serious nonoptimal outcomes. The Maastricht treaty is a perfect example.

General discussion: Several participants discussed the role of fiscal policy in the prospective EMU. Barry Eichengreen rejected the argument that EMU is undesirable because of the severe restraints that it would place on each nation's fiscal policy. He predicted fiscal flexibility would not be a problem because the binding restraints that Germany was trying to impose would be rejected and automatic fiscal stabilizers would be allowed to operate. Stanley Fischer believed the risk premiums that markets would apply to each nation's debt would help to provide discipline on fiscal policies. N. Gregory Mankiw noted that the size of such risk premiums would depend on whether it appeared feasible for a country to leave the monetary union once it had entered. To the degree that leaving the union did appear a feasible option, market discipline on fiscal policies would be stronger. But in that case, the advantages of fully credible monetary union were lost.

Christopher Sims believed that fiscal issues are a basic reason to be skeptical of EMU. Confronted with a sufficiently adverse shock, and with no relief available from an exchange rate depreciation, a country

could find itself in a downward spiral with interest rates rising sharply as markets questioned whether its debt would be salable. In these circumstances, it might opt out of the union as a final recourse. Alternatively, the central bank might respond by compromising its price stability target, or the crisis might be resolved in some other way. Sims noted that a supranational fiscal authority, which played the role that federal fiscal policy does in the United States, could get around such problems, but noted that no such institution was contemplated for EMU. James Tobin concurred with the need for fiscal stabilizers and with the problems inherent in relying solely on member states' fiscal policies. He feared that members' fiscal policies could be dictated by bond rating agencies. He predicted that in response to the diverse problems that individual nations are bound to encounter, a pan-European fiscal authority eventually would be adopted to provide credit guarantees of members' debts and other fiscal assistance to members who are in trouble. Cooper noted that the Brussels budget, amounting to about 3 percent of European GDP, already provides a form of pan-European fiscal authority, though one dedicated to structural transfers related to the common agricultural policy and income distribution rather than to cyclical stabilization.

Cooper was highly critical of the extreme independence and lack of accountability specified in the Maastricht treaty for the new European Central Bank, and of the bank's narrow charge to assure price stability. He argued that the ECB should ultimately be politically accountable either to a strengthened European Parliament (a pan-European approach) or to the Council of Ministers (a national approach) in the way the Bundesbank and Federal Reserve are accountable to representative bodies today. On the issue of responsibility, Cooper noted that the ECB's mandate does not even include assuring the functioning of the payment system and the stability of the financial structure, let alone employment stabilization.

Several participants offered observations favoring EMU, despite the doubts that had been raised about its impact on national stabilization. Eichengreen argued that the slow pace of regional adjustment that has been observed within national borders could not be applied to predict slow adjustment across national borders under EMU, because monetary union represented a regime change that would render past behavior a poor predictor. And he suggested that the alternative to EMU was

unattractive, reasoning that the exchange rate stability observed among potential members in recent years itself depended on the expectation that the monetary union would be formed. Robert Hall believed that the efficiency gains from conducting business in a single currency would be substantial, dominating any likely costs to economic stabilization under EMU.

Robert Shiller saw the willingness to form a monetary union as a historic watershed in the attitudes of Europeans. While the common currency's subordination of national monetary policy may create problems at first, he thought that ultimately the union would bring increased economic cooperation as well as favorable changes in wage bargaining and other key economic activities. Fischer emphasized the importance of monetary union as the force chosen by Europe's leaders to drive the political union. Regarding EMU's uncertain impact on economic performance; he reasoned that behavior and institutions would eventually adapt, with more wage and price flexibility and changes in social welfare and unemployment systems substituting for the monetary rigidities that EMU imposed. He acknowledged that such adaptations could take a long time, but believed that the benefits of political unity in Europe justified any transitory economic costs.

Susan Collins questioned how much of the credit for slowing inflation should be given to the EMS, the precursor to EMU. She saw little evidence that EMS members did better on inflation than other countries in the period since the EMS started in 1979. In recent years, the EMS members had eliminated inflation, but so had the United States, Canada, Japan and most other industrial nations. Furthermore, she reported that studies of the output cost of eliminating inflation show no cost difference before and after countries joined the EMS. This suggested that entering a regime of monetary discipline could not be relied on to produce greater wage and price flexibility and other institutional changes that might improve economic stabilization.

Collins also raised some issues about whether EMU would last, once it was established. On her reading of the past, big problems are likely to come from real rather than monetary shocks and so would not be mitigated by membership in a monetary union. Furthermore, because voters are much less enthusiastic about monetary union than are policymakers, they may become impatient with EMU membership if it stands in the way of dealing with their economic problems. She noted

that voters historically have seen economic problems as national, not regional responsibilities, which may help to explain why regional problems are often addressed at the national level. But EMU provides no means for furnishing such responses. Olivier Blanchard agreed that individual national economies might experience bad economic performance under EMU, but believed they would find it very costly to leave the union, especially if, some time in the future, all other members of the European Union were part of EMU.

Alesina agreed wth Collins that the history of performance under the EMS revealed no benefits to member nations, and provided no reason for optimism about performance under EMU. He also questioned whether benefits in the form of political unity, which Fischer had stressed, would be forthcoming. He noted that animosity among European nations has risen as EMU has approached. He saw this animosity as the result of imposing on nations things they did not want—a situation that would continue under EMU.

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