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Economic stability and choice of exchange rate regimes

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**Economic Stability and Choice of
Exchange Rate Regimes**

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Abstract

The purpose of this paper is to emphasize the importance of Europe's structural problems and governance as the cause of the current euro area crisis. The euro may have led to bubbles, but member economies were not free of trouble before the euro. Many members were losing competitiveness and in need of removing structural rigidities. If anything, the euro was expected to encourage structural reform, by taking away the easy choice of monetary and fiscal expansion. We first discuss the relationship between the single currency and economic stability in Europe. We confirm the asymmetries that remained after the introduction of the euro and then discuss the governance overhaul taking place in Europe today. This overhaul was something that should have been done before introducing the euro, and its advancement may be the silver lining of this crisis. Finally, we touch upon the implications for Asia and Japan, from the point of view of the choice of exchange rate regime as a method to advance necessary reforms.

JEL Classification: F33, F41

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1. INTRODUCTION

In the fall of 2009, the euro area fell into confusion, which soon developed into a full-blown crisis. Because the crisis is mainly in the periphery of the euro area, and because the European Central Bank (ECB) and European Commission form a troika with the International Monetary Fund (IMF) to resolve the situation, many view the euro as the cause of the crisis. However, abandoning the euro will not end the crisis. More importantly, not introducing the euro in the first place would not have assured stability and prosperity in Europe.

The purpose of this paper is to explain this, by emphasizing the importance of Europe's structural problems and governance as the cause of the current crisis.

The euro may have led to bubbles, but member economies were not free of trouble before the euro. Many members were losing competitiveness and in need of removing structural rigidities. If anything, the euro was expected to encourage structural reform, by taking away the easy choice of monetary and fiscal expansion.

Members of the euro area chose the single currency as their exchange rate regime. As with any choice, there were costs and benefits. One cost was the loss of monetary policy autonomy. The Stability and Growth Pact was supposed to constrain fiscal policy as well. On the benefits side, three benefits were expected from introducing the euro. One was to have a European currency rivaling the US dollar. Another was confirmation of the commitment of Germany and others to a "European Germany" instead of a "German Europe" (phrases attributed to Thomas Mann). The third was higher incentive and impulse for much-needed structural reform.

The third benefit resulted directly from the cost, because loss of policy autonomy enabled member states to bind themselves into a situation where they had no choice but to implement domestically unpopular policies such as budget cuts and structural reform.

That Europe needed structural reform was widely recognized by the time the euro came into being. The Lisbon Strategy of March 2000 expressed Europe's resolve to become, within the following 10 years, "the most dynamic and competitive knowledge-based economy in the world," which was "capable of sustainable economic growth with more and better jobs and greater social cohesion."¹ The euro was expected to help, by providing a constraint from the outside, enabling governments to implement policies that were unpopular inside.

The Lisbon strategy was reviewed in 2005, and the disappointing results of this midterm review led to its relaunch. There were some success stories but the strategy was not widely effective because it was based on peer pressure only. The new governance structure put into place by the relaunch aimed at increasing the sense of ownership by the member states, in cooperation with the European Union (EU) institutions. But the strategy continued to rely on the open method of coordination, based on voluntary cooperation and without any penalty or intervention in internal affairs. The relaunch may have increased the sense of ownership on the part of member states, but not on the part of their citizens. As foreseen,² without the increased sense of ownership on the part of citizens, many democratically elected governments were unable to remove inefficiencies and structural rigidities on their own. A quote attributed to Jean-Claude

¹ Presidency Conclusions, Lisbon European Council 23 and 24 March 2000, http://www.europarl.europa.eu/summits/lis1_en.htm

² For instance, Kaji (2007: 5) stated that "until EU citizens come to realise that they themselves have... responsibilities in reaching the Lisbon goals, the ultimate goal of Lisbon is unlikely to be reached," and predicted that "in as much as citizens in some Member States accept such responsibilities more than in others, the relative success in the re-launch will vary across the Member States."

Juncker's sums up the situation: "we all know what to do, we just don't know how to get re-elected after we've done it." Without stricter enforcement, Europe 2020³, the EU's new strategy, is bound to meet the same fate. This is why Europe is now undergoing a major governance overhaul.

The euro did not do the job it was expected to do—it did not push forward the necessary structural reform. This meant that asymmetries remained within the euro area, in terms of competitiveness and productivity. The one-size-fits-all monetary policy and the excessive deficit procedure were not enough to enable members to converge toward more efficient structures and fiscal discipline. Without convergence, it was clear even before its introduction that the euro would face difficulties. Fixed exchange rates and single currencies do not work well with asymmetries. In this sense, it is not surprising that we now have a crisis. The euro was structured in such a way that it would run into difficulty, if it failed to achieve one of its important objectives.

Below, we first discuss the relationship between the single currency and economic stability in Europe. We confirm the asymmetries that remained after the introduction of the euro and discuss the governance overhaul taking place in Europe. This overhaul was something that should have been done before introducing the euro, and its advancement may be the silver lining of this crisis. Finally, we touch upon the implications for Asia and Japan, from the point of view of the choice of exchange rate regime as a method to advance necessary reforms.

2. THE SINGLE CURRENCY AND ECONOMIC STABILITY IN EUROPE

Since the introduction of the euro, Asia and other regions have become skeptical of the single currency as an exchange rate regime conducive to stability. However, we must remember that getting rid of the single European currency alone does not stabilize the economy. Neither can we say that Europe would have been stable if only it had not introduced the euro. All exchange rate regimes have costs and benefits. By choosing an exchange rate regime, a country chooses the combination of such costs and benefits.

A country that chooses fixed exchange rates loses monetary policy autonomy.⁴ The exchange rate changes whenever one currency is sold in exchange for another. The act of selling one currency and buying another is initiated when there is asymmetry between the two countries involved. Asymmetry is the word economists use to describe the difference between two countries—difference in the sense that something exists in one country but not the other. The difference could be in monetary or fiscal policy, the need of one country to import something from another country, or the need to travel from one country to another. Asymmetries can also exist in the response of economic agents in the two countries, for example, to an outside shock such as the 1973 oil shock. If there is no asymmetry, there is no reason to buy one currency in exchange for another, and the exchange rate does not move. Exchange rates move in response to asymmetries. Fixed exchange rates and their ultimate form—a single currency—cannot last under asymmetry (unless the different asymmetries happen to cancel each other out).

³ http://ec.europa.eu/europe2020/index_en.htm

⁴ This is known as the Mundell-Fleming conclusions or the inconsistent triangle. By solving a simple two-country model for the reduced form for the exchange rate, we can see that exchange rates cannot be fixed when there is asymmetry (unless different asymmetries cancel each other out).

An autonomous monetary policy, if it is different in direction and magnitude from the other country's monetary policy, moves the exchange rate. So, if a country wishes to maintain a stable exchange rate, it loses monetary policy autonomy. The loss of monetary policy autonomy under fixed exchange rates is just one example of how a system of fixed exchange rates has difficulty coexisting with asymmetries.

The countries that joined the euro had reasons to join, even at the cost of losing monetary policy autonomy. One important reason was advancement of unpopular reforms. The single currency took away monetary policy autonomy, and fiscal policy autonomy to a certain extent. Loss of policy autonomy can mean policy discipline. The euro also made price and cost comparisons across borders far easier. All this was expected to leave the participating countries no choice but to move forward with the reforms.⁵

Through the reforms, the euro was expected to bring convergence of macroeconomic indicators in a desirable direction, reducing asymmetry in the euro area. But this did not take place as expected, and asymmetries remained. As long as asymmetry continues, so does the need for adjustment between member economies. From this point of view, it is no surprise that the crisis occurred.

Asymmetries call for adjustments. An adjustment variable must change to levels that correctly reflect the differences. If the exchange rate is floating, it becomes the adjustment variable. But in the euro area the exchange rate did not exist, so the needed adjustment could not take the form of exchange rate gyrations. The implicit exchange rate stayed stuck at a level that did not reflect the differences. The need for adjustment built up, and instead of exchange rates, sovereign borrowing costs quickly multiplied. .

The euro has so far been unable to contribute to the stable prosperity of its member economies. This does not mean, however, that the economies would have prospered stably if the euro had not been introduced. Europe was suffering from a fundamental structural problem, symbolized by the high rate of unemployment.

In responding to short-term economic downturns, structural reforms do not work quickly enough. But Europe's problems are not just short-term. If anything, Europe's problems can deteriorate through short-run recoveries, since recoveries can put off reforms that are needed for long-run prosperity. EU citizens' lives became stable thanks to social security arrangements and regulation to protect producers as well as consumers. But the institutions that contributed to the stability began to hinder job creation and innovation. Without removing such rigidities, Europe cannot enjoy long-term stability and prosperity. However, reform is difficult because of vested interests. In addition, euro members are democracies. Without majority endorsement, reforms cannot take place, even if they are desirable for the long-term health of the economies. This is not a strictly European problem; it applies to many countries, including Japan. It may not seem too relevant in other countries in Asia today, but once the growth rate slows down, the need for reform will become more evident and they will face the same problem.

⁵ The other reasons for joining the euro were (i) the participating economies are open, in the sense that transactions with foreign countries (in particular with each other) take up a high proportion of their gross domestic product (GDP), so the benefit from elimination of exchange rate movements is high and the cost of losing policy autonomy low; and (ii) it was important for Europe to have an international currency on a par with the US dollar—the end of the cold war made German reunification a reality and all members, including Germany, needed to reconfirm their commitment to Europe.

3. EUROPEAN EFFORTS TO ENHANCE STRUCTURAL REFORM

Those who support and sustain European integration were acutely aware of the need to press forward structural changes—they were actually taking measures to achieve this. The Lisbon strategy launched at the Lisbon summit in March 2000 was one of them, and the euro was expected to help. After the advent of the euro, reform progressed in some members but not in others. This was because implementation relied on peer pressure only.

The goal of Lisbon was “to make the EU the most competitive and dynamic knowledge-based economy in the world with more and better jobs and greater social cohesion in ten years”.⁶ The strategy was on the agenda at each successive summit. For example, the December 2000 Nice Summit decided to evaluate progress at every Spring meeting of the European Council. The March 2001 Stockholm Summit added a goal related to employment policies. In Barcelona in March 2002 new goals were introduced such as increasing the average retirement age by 5 years by 2010. The July 2003 Brussels Summit decided that the new member states should submit the annually published *Broad Economic Policy Guidelines* from 2004 in the form of updates and from 2005 in the form of implementation reports. Furthermore, members-to-be were to submit voluntarily the Cardiff reports on goods, services, and capital market reforms as of October 2003.

In parallel, André Sapir of the Université libre de Bruxelles published a report at the request of the European Commission (Sapir 2003).⁷ The report proposed the introduction of a tax to increase the EU budget, and a switch in spending from agriculture to investment. It also asked whether the open method of coordination, without sanctions, was sufficient to achieve the goals of the Lisbon strategy.

In 2004, the Kok report, led by former Prime Minister of the Netherlands Wim Kok, criticized the lack of political will for economic reform on the part of member states (High Level Group chaired by W. Kok 2004).

In spite of this, progress was slow and the European Commission had to propose that the European Council take action (European Commission 2005). The Council responded at the Luxembourg Summit in March 2005, in the form of a relaunch of the Lisbon Strategy with focus on growth and jobs. This relaunch introduced two new elements: (i) integration of the different guidelines; and (ii) the cycle of policy between the member states and the European Commission, via the European Council, Council of Ministers, and the European Parliament. These were introduced to reconsider the coordination between the EU and its citizens, and can be considered a forerunner to the extensive governance overhaul after the euro area crisis. The aim was to increase the sense of ownership on the part of member states, but it should have been clear that what was most needed was increased sense of ownership of citizens (Kaji 2007). No reform opposed by the majority of voters can take place in a democracy.

⁶ The European Commission prepared European Commission (2000a) for the Lisbon Summit, the conclusions of which can be found at http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.en0.htm.

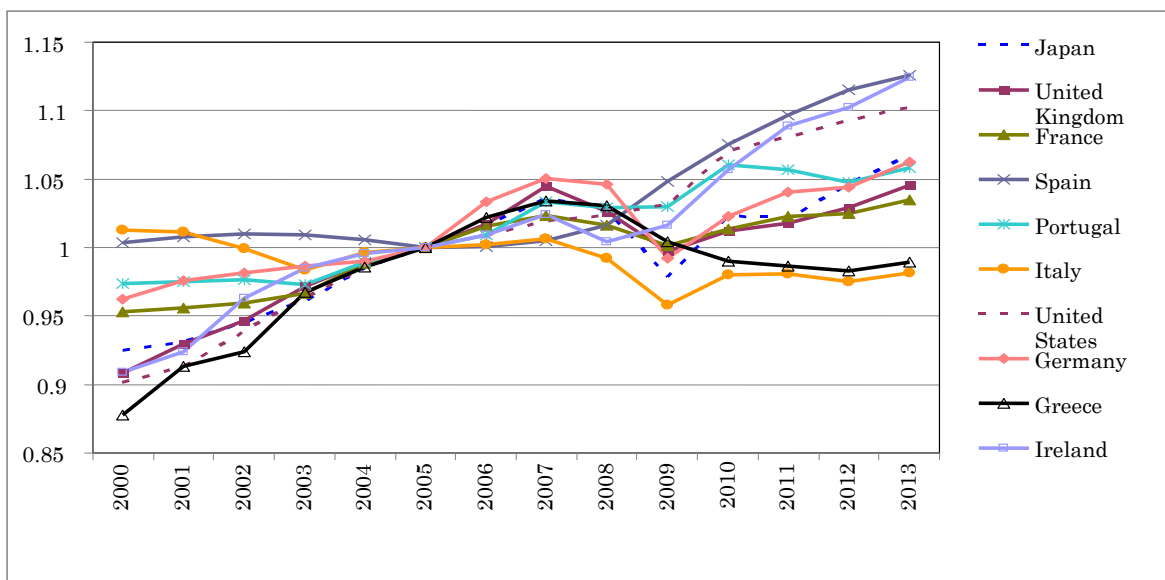
⁷ According to this report, “open method of coordination” was first used by Hodson and Maher (2001) and Rodrigues (2002). This method, already used at the Organisation for Economic Co-operation and Development (OECD) as well as in the business world, comprises four elements: (i) set common guidelines for member policies, (ii) develop performance indicators to compare best practices, (iii) demand that members adopt action plans for implementing the guidelines, and (iv) jointly monitor the results.

The open method of coordination has two potential difficulties. One is that it leaves unclear who is ultimately responsible. The EU sets the targets, by listening to the opinions of member states and their constituents. But it is the member states and their constituents that actually decide and implement the policies while taking into account feedback from the EU and other member states. On top of this, implementation can be left to many different agents such as national governments, regional governments, and social partners. This makes it very difficult to see where the ultimate responsibility lies. Another difficulty is that there is no sanction for failure to achieve the goals. Implementation relies on peer pressure only, which lowers the pressure for implementation.⁸ In hindsight, it is not difficult to see why the Lisbon Strategy did not attain its goals.

4. ASYMMETRY IN THE EURO AREA

This section describes some of the asymmetries in the euro area. Figure 1 shows the change in labor productivity (defined as gross domestic product [GDP] per hour) after the introduction of the Lisbon Strategy. The data are from the Organisation for Economic Co-operation and Development (OECD); Japan and the United States (US) are included for reference. After Lisbon, labor productivity declined in Italy and did not increase much (and declined after the crisis that started with the collapse of Lehman Brothers) in Greece. As expected, labor productivity increased in Germany. Less expected may be the increase in Spain, Ireland, and Portugal. In Spain and Ireland, the real estate bubble was a big factor behind the crisis, owing to insufficient financial supervision (Figure 2). There is some evidence of a bubble in Portugal as well, where the construction index declined to 59.9 in 2012 from 102.6 in 2006.

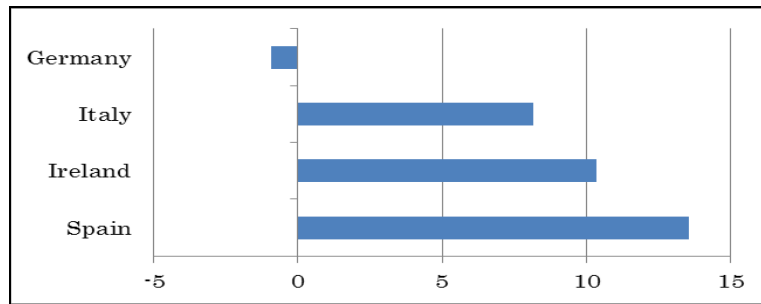
Figure 1: Change in Labor Productivity



Source: Organisation for Economic Co-operation and Development (OECD) Statistics, <http://stats.oecd.org/Index.aspx?Indix.aspx?QueryId=32453> (accessed March 2012).

⁸ When a supranational body does all three—sets the target, decides the policy, and implements the policy—the responsibility lies with that body. However, this is not sufficient for achieving goals because national governments may decide not to implement the policy. The introduction of sanctions increases the incentive for governments to follow policies set by supranational bodies.

Figure 2: Change in Housing Prices, 2001–2007 average



Note: Data for Portugal and Greece are not included in this data set.

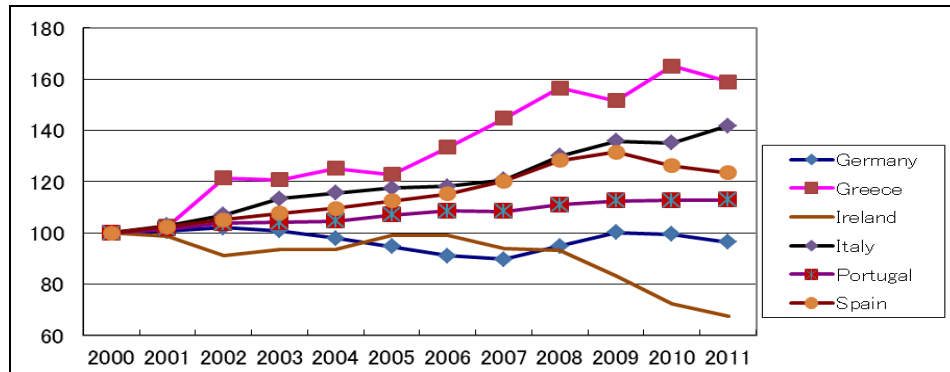
Source: Organisation for Economic Co-operation and Development (OECD), Economic Outlook No. 85: Statistics and Projections, http://www.oecd-ilibrary.org/economics/house-prices_2074384x-table17 (accessed March 2012).

When we compare the change in unit labor cost (Figure 3), we can see that lack of competitiveness played a part in Spain and Portugal.

Figures 3 and 4 show that, with the exception of Ireland, in all GIIPS (Greece, Ireland, Italy, Portugal, Spain) countries, the growth in labor cost was higher than the growth in labor productivity. Labor cost is affected by how much labor is protected (Figure 5). Many protective measures are justified, but too much protection discourages hiring, resulting especially in high youth unemployment.

Figure 3: Change in Unit Labor Cost for Manufacturing

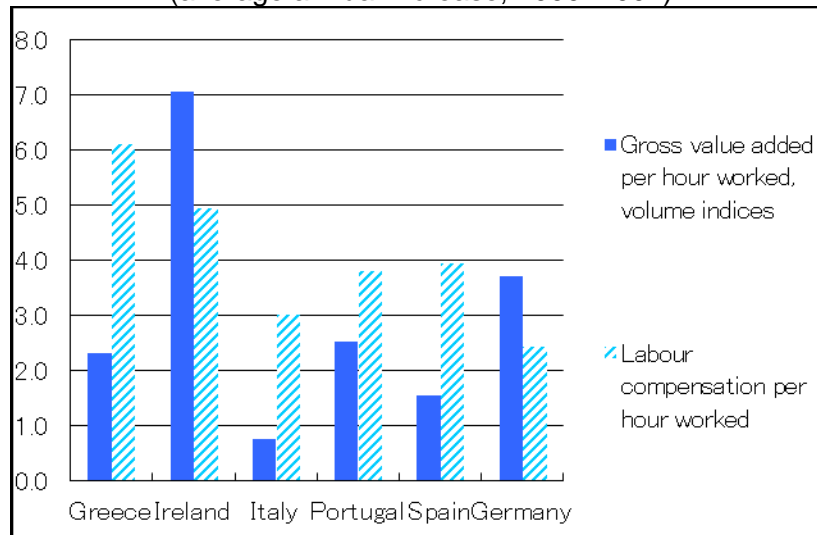
(year 2000 = 100)



Source: Organisation for Economic Co-operation and Development (OECD), Quarterly benchmarked Unit Labour Cost indicators—By economic activity, http://stats.oecd.org/Index.aspx?DataSetCode=ULC_QUA (accessed March 2012).

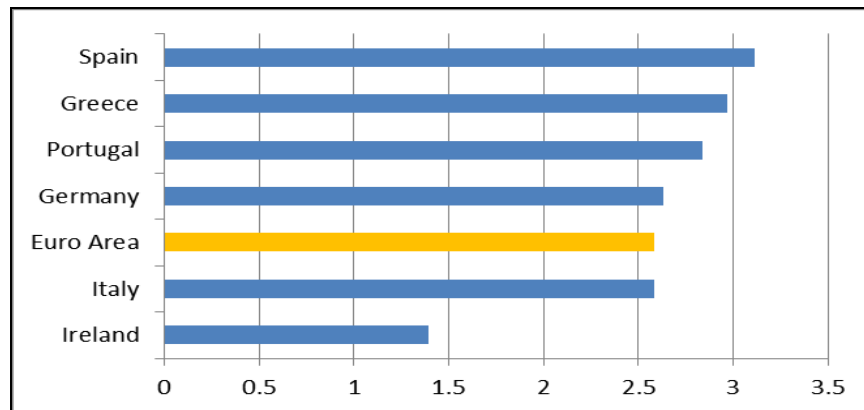
Figure 4: Productivity and Compensation per Hour for Manufacturing

(average annual increase, 2000–2007)



Source: EU KLEMS, Growth and Productivity Accounts, November 2009, <http://www.euklems.net/euk09i.shtml> (accessed March 2012).

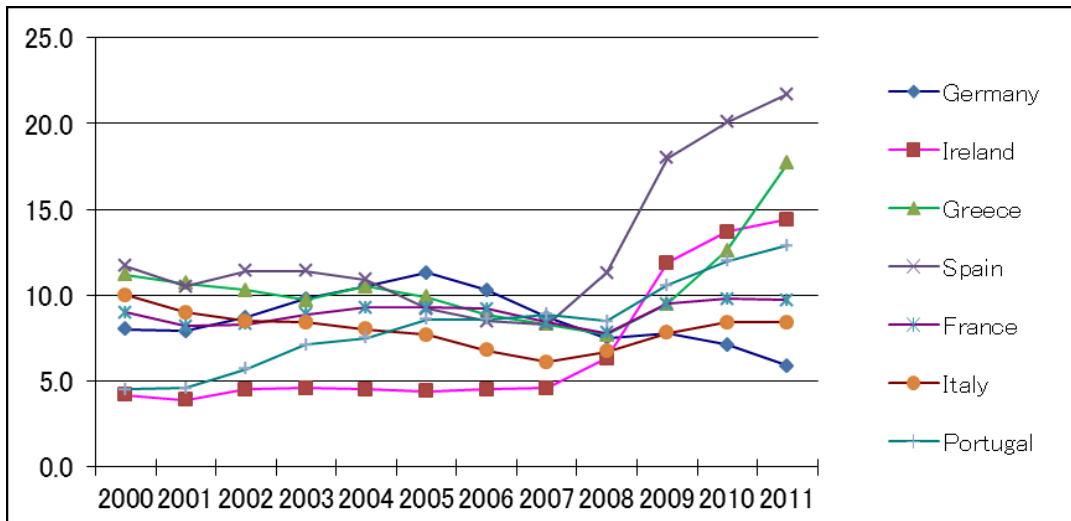
Figure 5: Employment Protection



Source: Organisation for Economic Co-operation and Development (OECD), Indicators of Employment Protection, www.oecd.org/employment/protection (accessed March 2012).

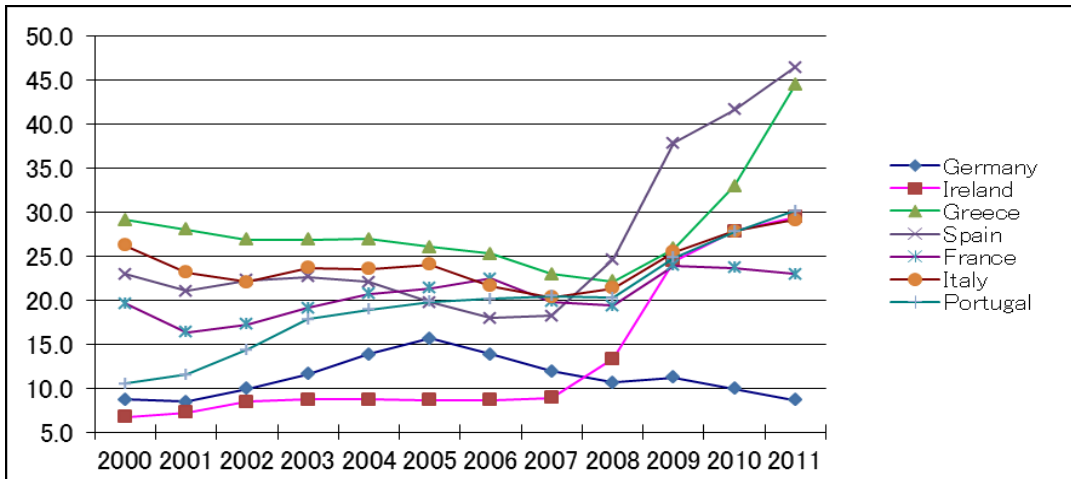
What is interesting in comparing the unemployment data between Germany and GIIPS (and France for reference) are the changes before and after the euro crisis (Figure 6). Before the crisis, there were years in which overall unemployment rates in GIIPS were lower than in Germany. This was overturned once the crisis began. One reason is the boom brought to Germany by the depreciation of the euro, which boosted Germany’s export competitiveness. Another reason is that GIIPS unemployment rates were kept artificially low before the crisis. Youth unemployment was lower in Germany even before the crisis, with the exception of Ireland (Figure 7). This is consistent with the analysis that low unemployment before the crisis was caused by protection of workers over the age of 25. The OECD’s product market regulation index provides another face of rigidity (Figure 8).

Figure 6: Unemployment Rates



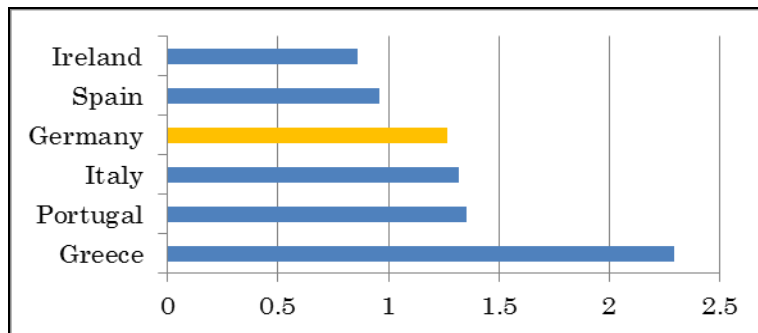
Source: Eurostat, Unemployment rate, annual average, by sex and age groups (%) (UNE_RT_A), <http://appsso.eurostat.ec.europa.eu/nui/show.do> (accessed March 2012).

Figure 7: Youth Unemployment Rates



Source: Eurostat, Unemployment rate, annual average, by sex and age groups (%) (UNE_RT_A), <http://appsso.eurostat.ec.europa.eu/nui/show.do> (accessed March 2012).

Figure 8: Product Market Regulation



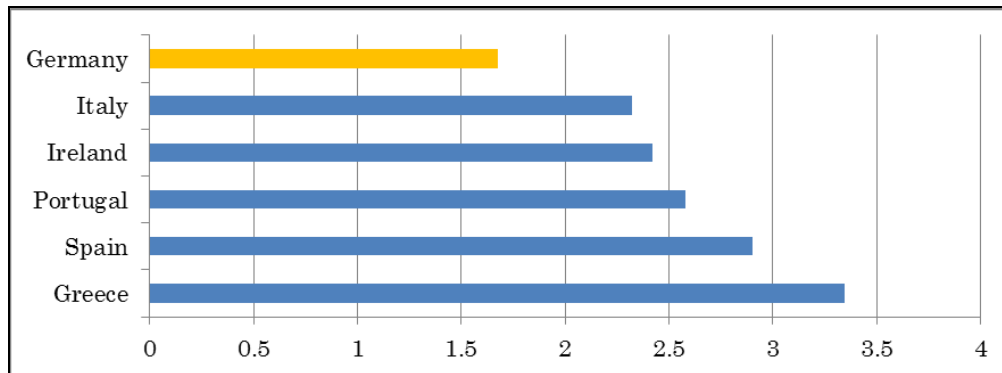
Source: Organisation for Economic Co-operation and Development (OECD), Product Market Regulation, http://stats.oecd.org/Index.aspx?DataSetCode=ULC_QUA (accessed March 2012).

Product market regulation (Figure 8) can take many forms, and some of them are just as justifiable as some employment protection. But post-crisis governments, both technocrat (Greece and Italy) and non-technocrat (Ireland, Portugal, and Spain), rushed to remove regulations that were hindering market entry and increasing the overall production cost of their economies.

Production costs are important elements of competitiveness. International competitiveness is often represented by real exchange rates.⁹ The real exchange rate is the relative price of domestic and foreign goods, comprising the domestic price, foreign price, and the nominal exchange rate.

Figure 9 shows average inflation rates from 2000 to 2011 for Germany and GIIPS, using the EU's Harmonized Index of Consumer Prices (HICP). Inflation rates did not converge as expected within the euro area. One reason could be differences in value-added tax (VAT) rates.¹⁰ Another possible cause is rigidities involving product price determination, production cost, and cross-border transactions.

Figure 9: Harmonized Index of Consumer Prices, 2000–2011 average



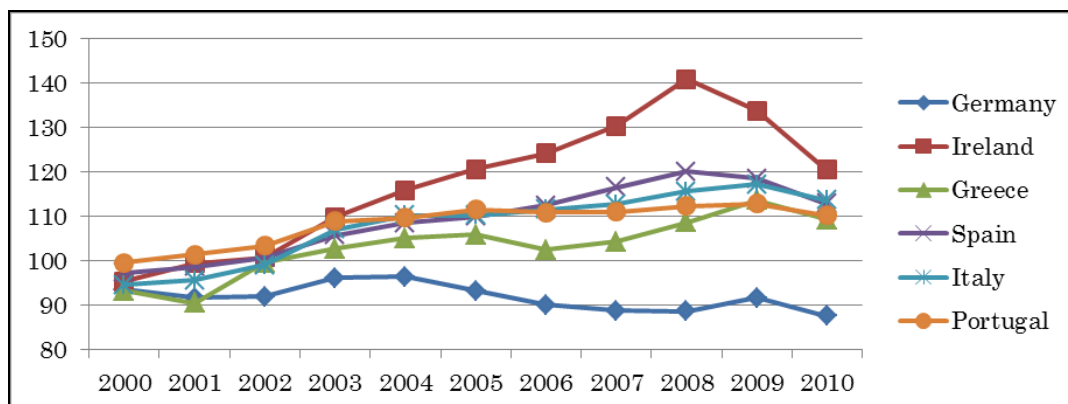
Source: Eurostat, Harmonized Index of Consumer Prices – Inflation rate, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb060&plugin=1> (accessed March 2012).

In contrast to the real exchange rate, the real effective exchange rate shows competitiveness in comparison to important trading partners because it is weighted using the trade shares with the country's trading partners. As we see in Figure 10, Ireland's lower inflation rate compared to other GIIPS did not help in maintaining competitiveness.

⁹ Not infrequently, the competitiveness of an economy or country as a whole is discussed using numerical values. However, such values at least partly reflect opinions expressed in surveys, and are hence not as scientific as the real exchange rate.

¹⁰ The European Central Bank reports that "(f)urther work is ongoing to improve the quality and comparability of the index. Key priorities for the coming years are the treatment of owner-occupied housing (currently excluded) and greater harmonisation of methods for quality adjustment and sampling. Eurostat and the national statistical institutes are also working on additional indices, for example an HICP index at constant tax rates" (European Central Bank <http://www.ecb.int/stats/prices/hicp/html/index.en.html>).

Figure 10: Changes in Real Effective Exchange Rates



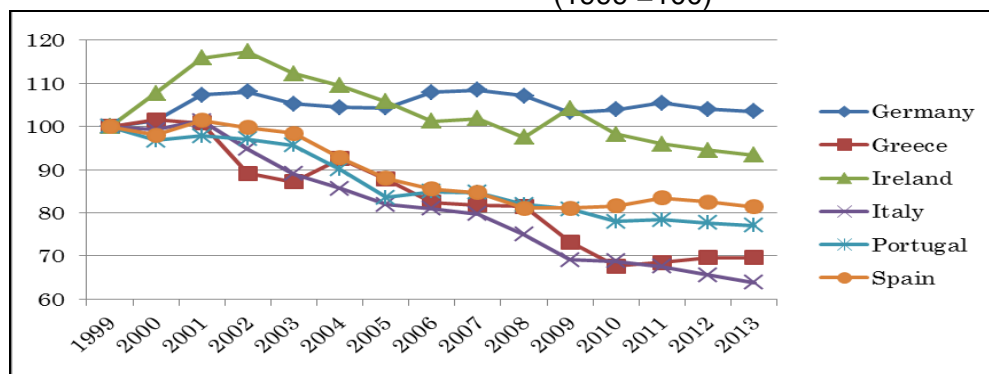
Source: Eurostat, Real effective exchange rate, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsdec330&plugin=1> (accessed March 2012).

5. THE SINGLE CURRENCY AND THE CURRENT ACCOUNT

Lack of competitiveness often manifests itself as current account deficits. The current account is the sum of the trade balance in goods and services, income balance, and current transfers. Thus, a current account deficit does not always signify low competitiveness in manufacturing. But Figure 11 suggests that GIIPS were losing their export share, and before 2009 their current accounts were in deficit.

Figure 11: Changes in Export Shares

(1999 = 100)



Source: Organisation for Economic Co-operation and Development (OECD), Exports of goods and services, volume, USD, 2005, forecasts after 2001, <http://stats.oecd.org/Index.aspx?QueryId=40569> (accessed March 2012).

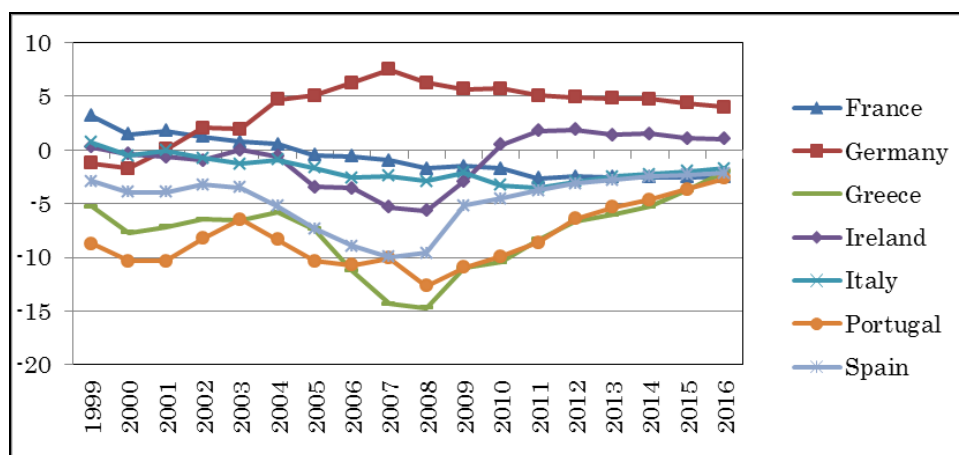
When a country has a current account deficit, the flow of funds into that country (borrowing) is larger than the flow of funds out of that country (lending). When this continues, net external debt can increase.

After the euro was introduced, the dominant view was that financing of current account deficits is not an issue within a single currency area. The reasoning was the following.

In the absence of an exchange rate, there is no exchange risk. Capital markets become truly integrated, and all current account deficits will be financed by private capital. Financing by public capital will no longer be necessary.

A current account deficit means that overall saving (public plus private) is lower than overall investment.¹¹ This means that a current account deficit country has borrowed more than it lent during the same period. The question is how to finance this net foreign borrowing. If private capital flows are tightly controlled to the extent they are nonexistent, the borrowing will be financed completely by a decline in foreign exchange reserves. But if private capital flows freely, and there is no exchange risk, private capital flows can finance all of the net foreign borrowing. In such a case, there is no need for foreign exchange reserves to decline. In addition, as there is no exchange market intervention, foreign exchange reserves will not decline as a result of selling foreign currencies. For these reasons, current account disequilibria (Figure 12) were considered to be a matter for the private sector, not the governments, in a single currency area.

Figure 12: Changes in Current Account Balances



Source: International Monetary Fund, World Economic Outlook Database, September 2011 (accessed March 2012) Forecasts after 2011.

The crisis made it abundantly clear that this was not the case. Financing of current account imbalances by the private sector did not last. Once the crisis began, governments had to take over this financing. As the possibility of default mounted, lending and borrowing among euro area governments became a huge issue for taxpayers. Figure 13 shows how accumulated current account deficits can amount to large stocks of net external debt.

Before the crisis, asymmetry in competitiveness manifested itself as current account imbalances within the euro area. Nobody paid much attention to it, because of the above reasoning that financing was a private sector issue. Greece and other nations ended up with current account deficits, which should have sent a strong signal that people needed to be aware of low competitiveness.

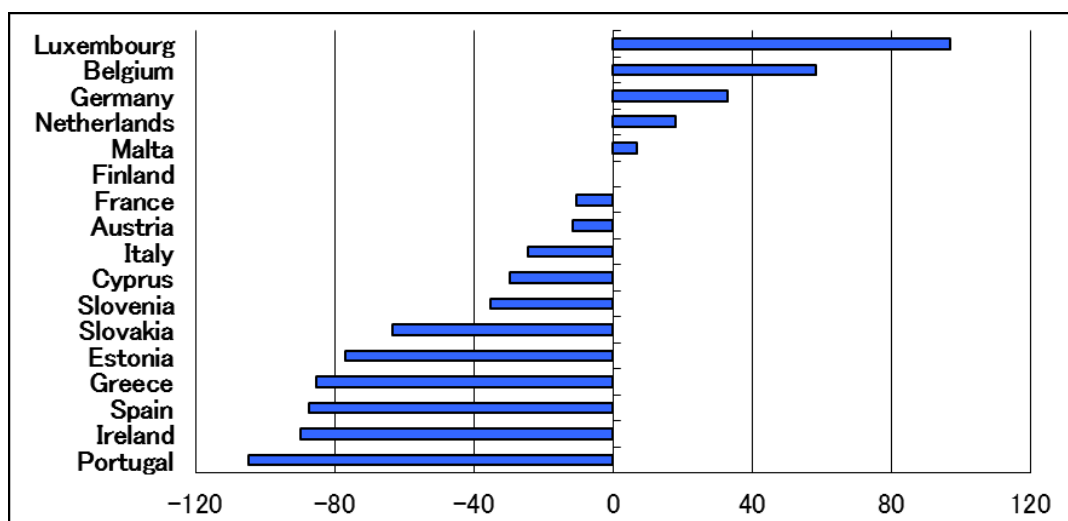
The crisis showed us the error we made about single currencies and current account imbalances. If asymmetries in competitiveness remain, they will show up as current account imbalances within the monetary union.¹² Private sector financing of such imbalances freezes up

¹¹ This is because the sum of (i) current account, (ii) capital account, (iii) change in foreign reserves, and (iv) errors and omissions add up to zero. The public plus private sector saving–investment balance is (ii)+(iii)+(iv). Nobody knows what comprises (iv) errors and omissions, which is why it is assumed as zero in the present explanation. It is important to remember that this equation (i)+(ii)+(iii)+(iv) = 0 is an accounting identity, and does not show a causal relationship, i.e., a current account surplus is not causing overall saving to be higher than overall investment and higher overall saving than investment is not causing a current account surplus. The two sides of this equation are in general simultaneously determined. A detailed explanation is given in Kaji (2006).

¹² Competitiveness is not the same as comparative advantage. A country can have comparative advantage even if the country is less competitive than other countries in the production of all goods and services. This is because

in crises, creating an enormous problem of potential default by one member government on another.

Figure 13: Net External Assets, 2008–2010 average



Source: Eurostat, Net international investment position in % of GDP – annual data
<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&tableSelection=1&labeling=labels&footnotes=yes&language=en&pcode=tipsii10&plugin=1> (accessed March 2012).

6. RIGIDITIES, GROWTH, AND FISCAL BALANCES

Among the asymmetries behind the current crisis, fiscal asymmetries are the best known. In fact, the crisis is most often explained as the GIIPS countries' failure to maintain fiscal discipline leading to reluctant rescue by Northern countries notably Germany. The reality, however, is far more complex.

In 2004, Germany and France broke the Stability and Growth Pact (SGP) without being sanctioned.¹³ The excessive deficit procedure against Germany was started on 19 November 2002. On 21 January 2003, the European Council warned Germany to take measures to reduce the excessive deficit as soon as possible (before 21 May). On 21 May, Germany was judged to have taken sufficient measures to reduce the deficit by 1% of GDP. However, Germany's deficit did not decline. At the Eurogroup Finance Ministers' meeting on 4 November 2003, Germany argued that they found a legal loophole to avoid being sanctioned based on the SGP. France supported this, but the Commission and smaller nations found this unacceptable. The then German Finance Minister Hans Eichel stressed that sanctions based on the SGP should not be

comparative advantage is about the increase in production of A by giving up one unit of production of B. If this A vs. B ratio is different between two countries, then there will be gains from trade by specialization. In contrast, competitiveness is about absolute advantage. All countries have comparative advantage in some good and/or service, but some have current account deficits and others have surpluses. If a country has an absolute advantage in some goods or services, it has a lower production cost than the country with absolute disadvantage in those goods and services. But a country is not likely to have absolute advantage in every single production process. The important point is that convergence in competitiveness does not mean all countries becoming alike. It means all countries becoming competitive in producing the goods and services in which they have comparative advantage, so that their current account deficits do not lead to dangerous levels of external debt, and their unemployment rates and government deficits remain at sustainable levels.

¹³ Details are in Kaji (2005), in Japanese.

automatic, and since both France and Germany were making efforts to reduce the deficit they should not be sanctioned.

For France, the excessive deficit procedure started on 2 April 2003. On 3 June, the Council had sent warning that the deficit should be eliminated by 2004 at the latest. On 14 July 2003, then President Jacques Chirac touched upon the SGP during an interview and became the first person to use the expression “flexible interpretation” in public. At the Finance Ministers’ meeting in October 2002, France was the only country that did not agree with the plan to reduce deficits by 0.5% of GDP starting in 2003. But this hardline approach against the SGP changed in 1 year, at the Eurogroup Finance Ministers’ dinner on 6 October 2003. Possibly, by this time there could have been a Franco–German agreement about the interpretation that sanctions should only be imposed on countries that are not co-operative. Finance Minister Eichel welcomed the change in the French attitude as a sign of a commitment to take the necessary measures to stay within the framework of the budget rules and discussions at the Economy and Finance Ministers’ meetings (Parker 2003a).

Austria, the Netherlands, and Finland were the most critical of the attitudes taken by France and Germany—they argued that sanctions had to be imposed. Italian Finance Minister Giulio Tremonti showed implicit support for Finance Minister Eichel’s interpretation (Parker 2003b).¹⁴ The euro area Finance Ministers’ meeting on 24 November 2003 ended at midnight, followed by Minister Tremonti’s one-on-one negotiations with other Finance Ministers based on the Italian blueprint, which lasted until 4:00 in the morning (Parker 2003c).

The Economy and Finance Ministers’ meeting held the following day did not adopt the Commission’s recommendation to impose sanctions on France and Germany. So these countries were not sanctioned, effectively removing credibility from the SGP.

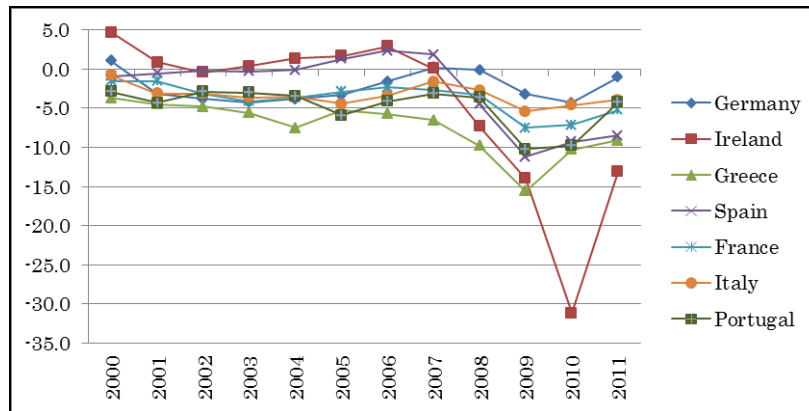
It would be hasty to conclude from this that Germany cannot criticize Greece because it broke the SGP in the past. By November 2004, 12 countries were judged to have excessive deficits. Aside from France and Germany, they were Portugal (revoked on 11 May 2004), the United Kingdom (UK), Slovakia, Poland, Malta, Hungary, the Czech Republic, Cyprus, the Netherlands, and Greece. The German economy had entered a recession in 2003, and there was the extra burden of west–east transfers caused by German reunification. It could be said that the coincidence of the end of the Cold War sealed the fate of the SGP.

As is clear from figures 14 and 15, until the current euro crisis, the fiscal situations in Spain and Ireland were better than in Germany—both in terms of deficits as well as debts in proportion to GDP. For these two countries, the cause of the crisis was partly contagion, partly the real estate bubble, and the lax financial supervision that led to it.

Spain’s problems are in the regions and in the banks. The central government finances may have been better than other euro members, but the regional finances were in worse difficulty. To get the situation under control on 3 June 2012, Spain’s Prime Minister Mariano Rajoy called for centralized control of national budgets. The non-profit, non-public regional savings banks (*cajas*) quickly ran into difficulties after the bubble burst. *Cajas* lent mainly to the underprivileged and the poor, and among those that ended up with huge losses was one led by a Roman Catholic priest. Hardly known outside Spain until the crisis, *cajas*’ assets total 40% of the Spanish financial sector. Bankia, in which the government had to inject €19 billion, was formed from a merger of seven such regional banks in 2010.

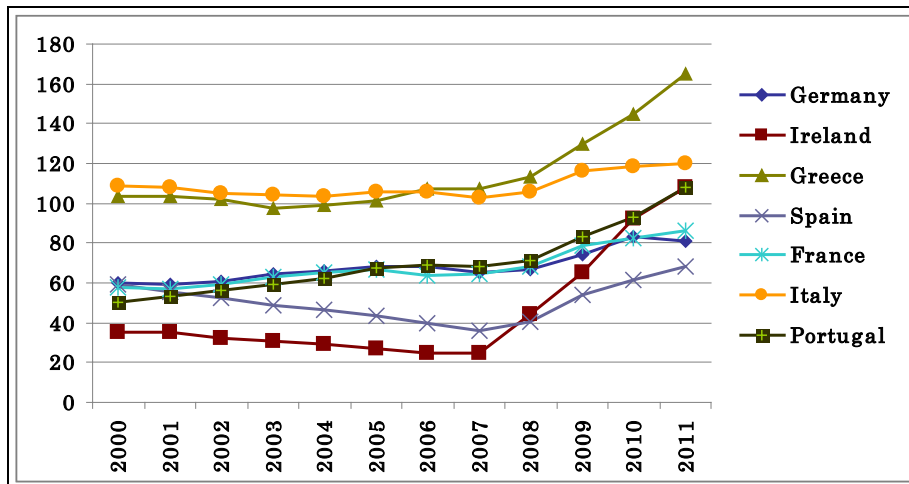
¹⁴ Italy was also coming under threat of an early warning on 28 April 2004. Early warnings were withdrawn, for Italy on 5 July 2004, and for Germany on 12 February 2004.

Figure 14: Changes in Deficit to Gross Domestic Product Ratios



Source: Eurostat, GDP and main components – volumes
<http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=teina200&language=en>
 (accessed March 2012).

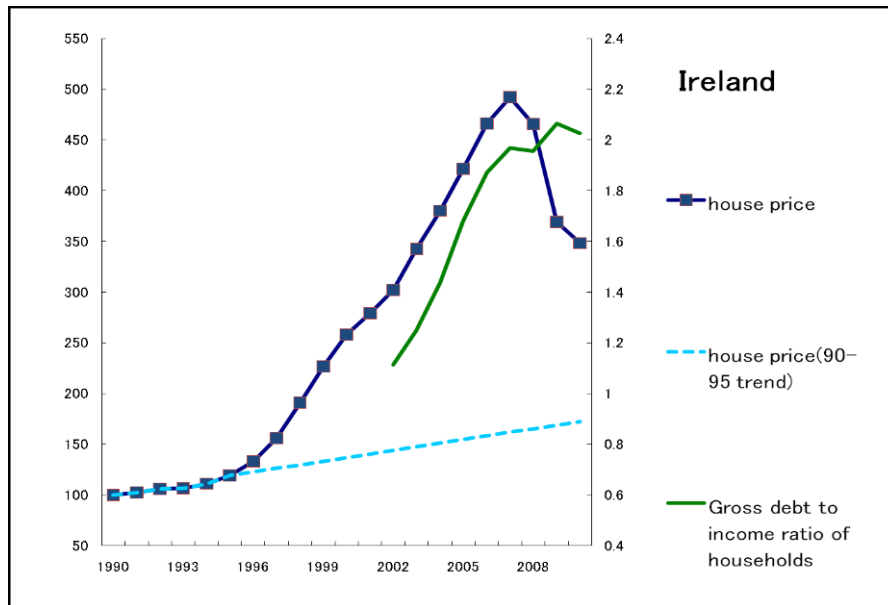
Figure 15: Changes in Debt to Gross Domestic Product Ratios



Source: Eurostat, General government gross debt (Maastricht debt) in % of GDP – annual data
<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=tipsgo10>
 (accessed March 2012).

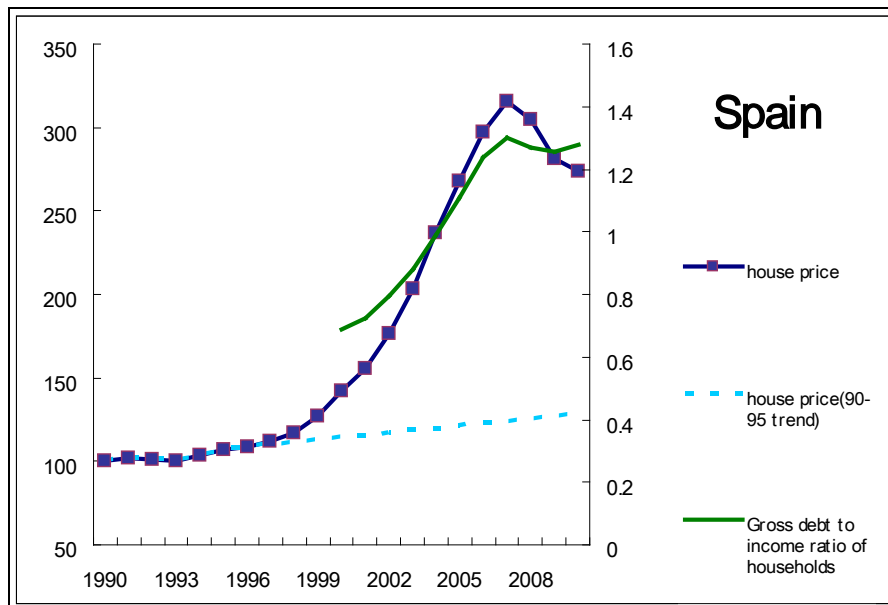
The Irish economy, the Celtic tiger, was directly affected by the Lehman crisis. By the second quarter of 2008, GDP growth dropped to -0.5% . In January 2009, Anglo Irish Bank and Irish Nationwide Building Society had to be nationalized. In November 2010, the EU and IMF agreed an €85 billion rescue package for Ireland. Figures 16 and 17 show the changes in housing prices and household debt to income ratio in Ireland and Spain.

Figure 16: Housing Prices and Household Debt to Income Ratio in Ireland



Source: Eurostat, Gross debt-to-income ratio of households and components
http://epp.eurostat.ec.europa.eu/portal/page/portal/sector_accounts/data/annual_data (accessed March 2012).

Figure 17: Housing Prices and Household Debt to Income Ratio in Spain



Sources: Sociedad de Tasación, Spain, http://web.st-tasacion.es/html/query_series_numericas.php;
 Eurostat, Gross debt-to-income ratio of households and components
http://epp.eurostat.ec.europa.eu/portal/page/portal/sector_accounts/data/annual_data (accessed March 2012).

7. GOVERNANCE OVERHAUL

We have seen how efforts at enhancing structural reform in the EU did not succeed, and how asymmetries remained in the euro area. This was because governance in the EU was not conducive to success. There were no sanctions and voters did not share the sense of ownership.

Japan knows very well the relationship between (or lack of) structural reforms and bubbles. In advanced countries with well-established social welfare systems and employment protection, where most households are well-stocked with consumer goods, the growth rate tends to go down. Monetary expansion is the easy, painless way to stimulate the economy without deregulation or structural reform. Lowering the interest rate does not hurt most voters; even those who depend on interest income have no reason to complain if a bubble develops to ensure plenty of capital gains. And a bubble will most likely develop, since there is a limit to using the extra money for purchasing additional goods and services. The money supplied will eventually head toward the real estate and financial markets. Not all bubbles develop this way, but this is one way to develop one. And when financial intermediaries ride the bubble and expand lending, the bubble expands. Spain and Ireland followed this pattern. In other words, insufficient structural reforms were behind all countries hit by the euro crisis.

Interest rates on all euro-denominated government bonds converged toward German levels. This led to reckless borrowing, not just on the part of governments but also private sector agents in some euro members. Private sector debt is just as dangerous as public sector debt, and in any case turns into the latter in a crisis. This is usually followed by lender of last resort actions by the central bank. This results in the improvement of balance sheets at banks, which then fund government spending to sustain the economy and the banks themselves. Banks with balance sheet problems and governments with balance sheet problems end up sustaining each other.

For Europe, the immediate task is to stabilize markets as well as to restore credibility in euro area sovereign debt and financial institutions. The difficulty lies in the fact that stabilizing markets and restoring credibility is one thing, while ensuring long-term stability is quite another. Whether or not any country leaves the euro, all countries inside and outside the euro area cannot enjoy sustainable prosperity without solid economic structures.

To have such structures, Europe needs governance overhaul at the EU level as well as national levels. Governance must be such that politicians who manage to implement unpopular but beneficial policies can be voted into office. If that is difficult, Europe can rely on supranational commitments—a choice that is still lacking in Asia. Europe is inevitably moving toward more interference in national policies. Integration is the only choice for peaceful economic stability in Europe. The crisis has made it clear that there is no longer any room for hesitation about further loss of sovereignty, for the sake of prosperous coexistence.

In October 2010, the task force chaired by the European Council President Herman Van Rompuy published its report (Van Rompuy Task Force 2010). It stresses the importance of (i) greater fiscal discipline, (ii) broader economic surveillance to include macroeconomic surveillance, (iii) deeper and broader coordination using the European semester, and (iv) a robust framework for crisis management. All of these involve major changes in governance.¹⁵

¹⁵ The explanation of the six-pack and the Treaty on Stability, Coordination and Governance (TSCG) below relies on European Commission (2012).

Governance is being overhauled to make the SGP more effective. First, the so-called six pack, a collection of five regulations and one directive came into force on 13 December 2011. Among other things, it introduced the debt rule in addition to the deficit rule. Parallel to this, the Treaty on Stability, Coordination and Governance (TSCG) was decided. The part of the TSCG related to fiscal balances is called the fiscal compact and is even stronger than the six-pack. First, the TSCG sets a lower deficit limit of 0.5% of GDP for the structural deficit (excluding cyclical effects and one-off measures), and of 1.0% of GDP for member states with a debt ratio significantly below 60% of GDP. Second, the budget rules must be written into national law, with “binding force and permanent character, preferably constitutional.” Third, the European Court of Justice may impose a financial sanction of 0.1% of GDP, if a country does not properly implement the new budget rules in national law, and fails to comply with a Court of Justice ruling that requires it to do so. Fourth, the decision on whether to impose sanctions will be made by reverse qualified majority voting among euro area member states, making it less likely that a blocking majority will be formed to stop the sanctions from being implemented.

Fiscal discipline is not the only focus. Sovereignty has to be given up regarding other aspects of the macro economy as well. Both the six-pack and TSCG include articles related to mutual surveillance of macroeconomic indicators. The six-pack includes surveillance based on the new Macroeconomic Imbalance Procedure.¹⁶ This is strengthened in the TSCG by including the ex-ante coordination of debt issuance plans. The TSCG also introduces economic partnership programs for member states in the excessive deficit procedure, which “detail the structural reforms needed for an effective and durable correction of their excessive deficit,” and a euro summit must be held at least twice a year.

The TSCG will be signed by 25 EU member states, excluding the UK and the Czech Republic, and is not EU law but an intergovernmental agreement. It will only be binding for all euro area member states, and will enter into force following ratification by at least 12 euro area member states. This is expected by the 1 January 2013, after which it will run alongside the six-pack. The goal is to turn it into EU law within 5 years. As of March 2013, only countries that ratify this agreement will have access to support from the European Stability Mechanism. After 1 year of coming into force, only countries implementing the fiscal rules of this agreement will have such access.

This can be interpreted as the EU’s opinion that it is no longer willing or able to stay in the same boat as members that do not or cannot stimulate their economies and stabilize their finances. There is perhaps also the hope that profligate and tardy members will finally speed up their reforms after seeing the stricter conditions. The EU has long been aware of the democratic deficit and has been making efforts, ineffective as they may have been, to increase the sense of ownership of its citizens. It is asking citizens to reflect on what the EU is worth to them. Even Germany, with its regional finances in deficit, cannot be expected to provide funds indefinitely. Rather than see a wholesale collapse, the EU is turning toward continuity and stability with members that are ready and able to come along.

A poll published by Pew Research Center on 29 May 2012 showed that in six of the eight countries surveyed, the majority believed that European integration had damaged their economies. The six include Spain (by a narrow majority), France, Italy, and the UK (by large majorities). Only in Germany and Poland, majorities answered that the EU has been good for

¹⁶ The Euro Plus pact also strengthens the Macroeconomic Imbalance Procedure. The Euro Plus Pact: Stronger Economic Policy Coordination for Competitiveness and Convergence was adopted during the EU Council on 24–25 March 2011. It sets common goals in four areas—strengthened competitiveness, increased employment, fiscal sustainability, and financial stability—to be aimed at through mutual surveillance.

prosperity. What such a poll does not ask, however, is whether citizens are ready to give up all that integration has already given them. For the EU to continue to exist, it must continue to change, in ways that some voters are finding objectionable. But just because majorities are finding the changes objectionable, it does not mean they are ready to accept the consequences of not making the changes.

When times are hard, extremists on both the right and the left see an increase in support. That is the danger. The new President of France won the election promising a renegotiation of the fiscal pact. Fortunately, this is unlikely to mean rewriting of the whole text—rather, an addition of a growth pact. But a Franco-German agreement at the level of heads of state is not the final word. The real test is whether citizens will choose to pay the price for enjoying the past and future fruits of integration.

8. CONCLUSION: IMPLICATIONS FOR ASIA AND JAPAN

It is not clear whether Europe can complete all the necessary steps of governance overhaul. Germany's Constitutional Court must find it legal, and France is one of the members to which sovereignty is very important. Even if the proposed changes are accepted by the member states, there is the more immediate task of solving the debt crisis.

There are many contradictions in post-crisis policy making. For instance, to induce structural reform, monetary and fiscal policies need to be constrained, but that should not push economies into severe depression. Voters, not just in Greece and France but also in the Netherlands, are against more austerity. Policies need to be loose enough to maintain economic activity and satisfy voters.¹⁷

To maintain healthy financial intermediation, capital injection into banks is necessary, but workers in other industries will not find this fair. To stabilize markets, certain financial controls and regulation are necessary, but too much control and regulation is harmful to the smooth operation of financial intermediation.

When voters in Germany, Finland, the Netherlands, and Austria ask for collateral for lending more to the periphery countries, all they are expressing is concern over moral hazard. And when markets demand a higher cost of financing profligate states, all they are asking for is sustainability by fiscal discipline.

Because of all these contradictions, post-crisis policy making involves walking a fine line. One wrong step and markets might even destroy the single currency.

However, the long-run goal remains unchanged. Without proper governance, Europe will not be able to implement the changes necessary for continued stable prosperity. Members that do not wish to give up the required amount of sovereignty will have to opt out. The EU needs to be very vigilant of the consequences of such advanced “variable geometry.”

The question of how much sovereignty to give up for the sake of peaceful prosperity is shared by all nations. Europe is the first region of the world to tackle this question head on. It can be rephrased as how to conduct unpopular but beneficial policies in democracies. In other words, whether a country can avoid a sovereign debt crisis and maintain economic stability depends on how well a democracy is functioning. Europe's answer to these questions is integration.

¹⁷ In that sense, President Hollande's proposals work to regain the balance. However, if fiscal policy is to be loosened, it must involve forward-looking spending that encourages investment and employment, rather than backward-looking spending that maintains the status quo.

Criticizing integration is easy, but those who criticize must show an alternative. The euro may have failed to achieve its main goal, but if governance is improved as a result of the crisis, that would be the silver lining.

It is one thing to experience a debt crisis, quite another to lack competitiveness. This lack of competitiveness is at the heart of the current euro area crisis—not the single currency. This is precisely why Europe is undergoing a major governance overhaul. EU level intervention in domestic policy making is disdained and disliked. But the current crisis has revealed that, without such intervention, at least some members are unable to refrain from the kind of overspending that endangers the well-being of the region if not the world.

In this sense, sovereign risk is closely related to the choice of exchange rate regimes, but not just in the sense that fixed exchange rates invite speculative attacks. Choice of exchange rate regimes can decide the likelihood that a country can implement painful reforms, so that a sovereign crisis can be avoided. If domestic political pressure is such that reforms are impossible, the country needs to enter some kind of external arrangement, perhaps an exchange rate system that provides the necessary constraint. Alternatively, it might take the form of an economic partnership agreement. If, on the other hand, voters can choose a government that conducts policies that increase competitiveness, then supra-nationally imposed constraints are not called for.

Turning our eyes to Japan, the debt–GDP ratio is the worst in the advanced world, and the cost of maintaining the current social security system increases by ¥1 trillion per year. Nevertheless, reform to nurture new industries and/or to lower anxiety over caring for children and the aged is slow. Rather than criticize the euro, the Japanese need to recognize integration as an incentive for reform. The single currency managed to close the easy way out for some member states, helping them to succeed in moving forward with reforms. How will Japan close its easy way out?

Governance is also important as Asia considers its choice of exchange rate regimes and economic agreements, with the goal of economic stability. Growth is still high in Asia, excluding Japan, but some countries are already worried about a middle-income trap. If a country cannot establish and maintain an economic structure conducive to sustainable economic growth, it needs outside pressure and even constraints. With increased financial and real interdependence, one country's crisis quickly spreads to its neighbors. This externality needs to be taken into account when deciding regional policy on real and monetary integration. An era may be dawning in which sovereignty takes a backseat to supranational imposition of sustainable structures. Otherwise, the situation can be prone to crises and hence dangerous. If that is the case, there is all the more reason to ensure that such supranational arrangements are of a peaceful and friendly nature, resulting from close cooperation and consultation among its members.

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