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Special Issue: How to Cope With Divergence in an Enlarging European Union?

Editorial to the Special Issue

Eckhard Hein and Achim Truger***

Although growth in the European Union (EU), and in particular in Germany, one of the Euro area's former »sick men«, has speeded up in 2006, the EU and particularly the Euro area continue to face major economic problems. These problems are caused by the restrictive »Maastricht economic policy regime«. To put it shortly, this regime is dominated:

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

Above all, the latter will exert deflationary pressure on the Euro area as a whole as soon as the next recession materialises. This in turn will not only exacerbate the economic problems within the EU but it might even endanger the political project of European integration as such.

Against the background of this restrictive policy mix, EU enlargement and the inclusion of the central and eastern European countries has considerably increased the degree of nominal and real differences within this economic area. And it is not at all clear whether and how the EU will be able to cope with these differences and the already existing tendencies of divergence among the »old« member states.

The 10th workshop of the Research Network Macroeconomic Policies in October 2006 in Berlin therefore focused on »European Integration in Crisis«. The papers presented at this workshop attempted to evaluate the state of European economic integration, the economic policy strategies applied, and the perspectives for economic and currency in-

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tegration. In this special issue we have included four papers dealing with the problem of divergence in an enlarging EU from different angles, but with a focus on monetary and financial issues.¹

Catherine Mathieu and Henri Sterdyniak focus on »How to Deal With Economic Divergences in EMU?« They argue that since the launch of the euro, persistent and even rising disparities among member states have made it difficult to implement common economic policies. Mathieu and Sterdyniak consider four explanations for Euro area disparities and imbalances: first, the benefits of the single currency for catching-up countries; second, the weaknesses of the Euro area economic policy framework; third, the implementation of non-cooperative domestic policies inducing excessive competition and insufficient coordination hurting mainly the larger economies; and fourth, the crisis of the European continental model in a global world. Four economic policy strategies to cope with these tendencies are then discussed: first, increasing market flexibility; second, moving towards the knowledge society of the Lisbon Agenda; third, re-nationalising economic policies; and fourth, introducing a more growth-oriented policy framework.

In »International Capital Flows Within the European Monetary Union: Increasing Economic Divergence Between the Centre and the Periphery«, Sergio Rossi aims at investigating some neglected consequences of free capital mobility in the Euro area. His approach is based on the book-keeping nature of money, which shows that capital – in the form of bank deposits – is mobile within a currency area but actually immobile between different monetary areas. Rossi argues that within the Euro area both short- and long-term investments are directed into those economies with the highest return on investment. Since the return on investment is positively related to the rate of real growth, economic divergence might increase between member countries of the EMU. This will give rise to a higher rate of unemployment in those member countries that suffer from net capital outflows, whereas the other countries in the same area will benefit.

Michael Holz argues in favour of »Asset-Based Reserve Requirements: A New Monetary Policy Instrument for Targeting Diverging Real Estate Prices in the Euro area«. Since the ECB has to conduct monetary policy for the Euro area as a whole, its policies affect countries with rapidly rising housing prices (e.g. Spain) in a markedly different way than those with stagnating housing prices (like Germany). Therefore, in order to deal with divergent real estate prices within the Euro area, interest rate policy is not the appropriate instrument according to Holz. But he argues that »fine tuning« may be possible with the help of asset-based reserve requirements. All financial institutions would be forced to deposit them at the ECB with reserve rates being free to vary between countries. Reserve rates should be highest in those countries where appropriate indicators signal a housing price bubble.

In »Capital Flows, Turbulences, and Distribution: The Case of Turkey«, Özlem Onaran deals with the mechanism of the boom-bust cycles in the context of domestic and international financial liberalisation in Turkey as a developing potential accession coun-

1 Further papers from the conference have been published in Hein/Priewe/Truger (2007).

try. She also analyses the effects of crises and exchange rate volatility on functional income distribution. Turkey has experienced two severe crises in 1994 and 2001 after the liberalisation of capital flows and has also been hit the hardest during the May-June 2006 turbulences. The paper analyses the recent turbulences in the global economy and their consequences for an emerging market country also as a case study to illustrate the endogenous formation of expectations. According to Onaran, the recovery in Turkey after the turmoil is not based on a solution to the structural causes of the problem, since it has completely depended on the reversal of the capital outflows thanks to high interest rates. The long-term effects of this process are not yet clear.

We would like to thank the contributors to this special issue for their cooperation, the referees for their timely and constructive reports, and the participants in the conference for the stimulating discussions. Special thanks go to Barbara Schnieders for the assistance in the editing process and to the Hans Böckler Foundation for organisational and financial support of the conference and the publications, and – in particular on the occasion of the 10th workshop – for the support of the activities of the Research Network Macroeconomic Policies during the last decade.

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