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## How the Maastricht regime fosters divergence as well as fragility

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## Working Paper No. 460

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### **How the Maastricht Regime Fosters Divergence as Well as Fragility**

by

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## **ABSTRACT**

This paper investigates the phenomenon of persistent macroeconomic divergence that has occurred across the eurozone in recent years. Optimal currency area theory would point toward asymmetric shocks and structural factors as the foremost candidate causes. The alternative hypothesis pursued here focuses on the working of the Maastricht regime itself, making it clear that the regime features powerful built-in destabilizers that foster divergence as well as fragility. Supposed adjustment mechanisms actually have turned out to undermine the operation of the currency union by making it less “optimal,” that is, less subject to a “one-size-fits-all” monetary policy and common nominal exchange rate, in view of the resulting business cycle desynchronization and related build-up of financial imbalances. The threats of fragility and divergence reinforce each other. Without regime reform these developments could potentially spiral out of control, threatening the long-term survival of EMU.

**Keywords:** Economic and monetary union, optimum currency area theory, wage-price flexibility, divergence, imbalances

**JEL Classifications:** E52, E58, E61, E63, E64, E65

## 1. INTRODUCTION

This paper investigates the phenomenon of persistent macroeconomic divergence that has occurred across the Euro area in the fragile macroeconomic environment of recent years. Optimal currency area theory would point toward asymmetric shocks and structural factors as the foremost candidate causes. The alternative hypothesis pursued here focuses on the working of the Maastricht regime itself, highlighting that the regime features powerful built in destabilizers that foster divergence as well as fragility. Supposed adjustment mechanisms have turned out to actually undermine the operation of the currency union by making it ever less “optimal,” that is, less subjectable to a “one-size-fits-all” monetary policy and common nominal exchange rate in view of the resulting business cycle de-synchronization and related build up of financial imbalances.

The issue of divergence across the eurozone has gained some prominence in recent years. Often attention is primarily focused on inflation differentials, which are however not necessarily judged undesirable. For instance, in its May Bulletin of 2005, the European Central Bank (ECB) observed that:

“Inflation differentials can be an integral part of the adjustment mechanism resulting from dispersion of economic developments across the participating countries, a mechanism which in turn reflects the impact of various economic shocks as well as the fact that the economic structures in place vary from country to country. Inflation differentials are, then, the product of an equilibrating adjustment process within a monetary union and, as such, are not only unavoidable, but also desirable. At the same time, lasting inflation differentials in the euro area are, to some extent, also a product of misaligned fiscal policies, diverging wage developments and deep-seated structural inefficiencies such as nominal and real rigidities in product and factor markets” (ECB 2005, May MB, p. 61).

Note that inflation differentials are seen here as part of an *equilibrating adjustment mechanism* featuring wage and price flexibility. And a related issue is that structural reforms enhancing flexibility are then seen as bolstering the working of these supposedly equilibrating forces. By contrast, the analysis here will pinpoint that powerful forces of divergence triggered in the process are ignored in the official flexibility doctrine and that substituting structural reform and flexibility for proper demand management is doomed to failure.

The analysis starts in section 2 with the ill-conceived “convergence process” of the 1990s. Developments since the euro’s launch are the subject of section 3.

Section 4 then turns to optimum currency area theory for advice on the issue of divergence within currency areas. A thorough analysis of the “competitiveness channel,” the various forces of divergence kicked off thereby, and their joint effect on internal economic stability of individual member states is provided in section 5. The accompanying build-up of intra-eurozone imbalances is the subject of section 6, which also identifies the key flaws in the reasoning behind the official flexibility doctrine. Section 7 concludes the analysis and offers recommendations for regime reform targeting the divergence issue.

## **2. DIVERGENCE DURING THE “CONVERGENCE PROCESS” OF THE 1990S**

Before setting out to investigate the phenomenon of persistent divergence in inflation and economic activity across Euroland since 1999 two issues require prior clarification. One concerns the catching-up process of lower-income EU members with their higher-income partners. Another is that persistent inflation differentials and cyclical divergence are not new phenomena in Europe.

As to the first, growth theory would lead one to expect that, for instance, the latecomers in Europe’s south, Greece, Portugal, and Spain, just like the new EU members in Europe’s east, will grow faster than the “old EU core” for as long as their catching up and real convergence to a supposedly common (long-run) growth trend is taking place. Essentially, this can be thought of as an equilibrium phenomenon during which both higher and lower-income countries can grow at their respective potential trend rates. And long-run catching up is not the issue in what follows. Instead, at issue are pronounced *out-of-sync* deviations from steady-state growth and persistent inflation differentials not attributable to the Balassa-Samuelson effect. In principle, cyclical divergences can get either amplified or effectively counterbalanced, and by either market mechanisms and/or stabilizing policies.

In actual fact, pronounced cyclical divergences much characterized the situation since 2001. In particular, while domestic demand and economic activity in Germany has remained severely depressed, France fared significantly better until recently, and Spain experienced boom conditions throughout. In other words, while Germany has suffered from protracted cyclical slack, Spain enjoyed sustained above-trend growth, with France and Italy falling somewhere in between. Similarly,

persistent inflation differentials remain in place, with Germany well below and Italy and Spain well above the eurozone average. Among smaller countries Portugal and the Netherlands have been persistent laggards and Ireland and Greece persistent star performers. The point is that for members of a common currency area such a lack of synchronization of business cycles can represent a serious problem since the common monetary policy stance and external exchange rate tend to become increasingly less “optimal” the further member countries are drifting apart.

And this leads to the second issue, the fact that cyclical divergence and persistent inflation differentials are not new phenomena in Europe at all, but characterized the whole post-war era up to EMU too. In the past, such diverging trends led to external imbalances and periodic exchange rate adjustments or crises. These were however always considered a threat to the common market and further economic integration, which is exactly why Europe undertook a fresh attempt at creating a “zone of monetary stability” in the late 1970s (the EMS), and then embarked on the common currency project in the late 1980s (EMU). EMU was supposed to ban forever the possibility of competitive devaluations that could disturb or even undermine the common market and European integration more generally.

However, by the time this was agreed upon in the early 1990s Europe suffered from very severe divergences indeed, both in inflation and economic activity. It was to prepare the launching of the common currency into a more stable environment that a period of convergence was prescribed to precede the euro’s introduction. The Maastricht Treaty features certain criteria that countries had to fulfil in order to be allowed into the club. These criteria set limits for inflation, nominal interest rates, nominal exchange rate changes, and public finances; apart from requiring the release into independence of national central banks before merging them into the Eurosystem.

As it turns out, actual occurrences over the 1990s foretold many of the problems that countries were to experience under EMU conditions more recently too. While inflation and nominal interest rates generally fell to common and low levels and budget deficits declined to just below 3 percent of GDP by 1997-98, too, developments in the real economy during the 1990s were anything but harmonious (Arestis and Sawyer 2001).

The decade started out in 1990 with what represented a sizeable asymmetric shock hitting the anchor currency. In Germany’s case, unification extended the belated boom that had reached the country only by 1988, after subdued growth ever

since the early 1980s recession. Among other things, Germany's miraculous four-year span of high growth at stable and low inflation paid put to the popular contemporary view that Germany was suffering from all-pervasive structural problems that prevented it from growing. By contrast, and despite export spill-overs from Germany's so-called unification boom, much of the rest of Europe was facing stagnation if not outright recessionary conditions by that time.

This marked de-synchronization of business cycle conditions, together with the Bundesbank's extraordinarily tight money course embarked upon in 1991, led up to the ERM crises of 1992/93. The sizeable devaluations "suffered" by many satellite currencies vis-à-vis the deutschmark in these events corrected for Germany's creeping competitiveness gains that had accumulated during the "hard EMS" period. While it would thus be wrong to conclude that Germany had to restore its competitiveness lost through these events, their impact no doubt represented the first source of subsequent divergence, with competitiveness gains boosting exports in countries like Italy and Spain, but having the opposite impact on Germany. The loss of Germany's previous (undervaluation) advantage was one of two main factors that reversed the direction of diverging trends over the course of the 1990s: Germany had started out as the strongest economy in Europe when the common currency was agreed upon, but turned out to be its weakest when the euro was actually launched.

The turning point occurred around the middle of the decade. By that time, however, all of "Euroland to be" found itself in the doldrums. It is worthwhile to recall here that even in mid-1997 it appeared that only a very small group of countries would qualify for an early euro adoption. The fiscal contractions inflicted upon Europe at the time – although at varying degrees and timings – proved rather less expansionary than its propagators had promised they would. Accompanied by the Bundesbank's conspicuous reluctance to ease policy, referring to a stability-oriented need for a "steady hand" policy, an argument never heard of when the bank envisions reasons to hike rates, the predictable consequence was subdued growth.

Luckily, the United States' "new economy" boom and associated U.S. dollar strength provided a last-minute lifeline to the struggling EU economies; just in time for the "convergence test" of spring 1998 leading to a broad EMU after all.

Luck proved short-lived though as the Asian and Russian crises soon after delivered a sizeable external demand shock. Germany was especially hard hit because already at that point the country had become overly reliant on export-driven growth.

In Germany, domestic demand failed to ever recover from the Bundesbank's tight money crusade that accompanied the severe and procyclical fiscal contraction between 1992 and 1997 – an exceptionally (and counterproductively!) tight macro policy stance that diverged from the situation in much of the rest of Europe.

For one thing, other countries like France, Spain, and Austria for instance, wisely delayed the bulk of their fiscal consolidation efforts until the worst was over, thereby avoiding the strongly procyclical impact that characterized Germany's situation. For another, the years 1996-98 saw non-deutschmark interest rates across Europe converge (i.e. decline) to German levels, traditionally the European interest rate floor (except for the Swiss franc) related to Germany's EMS lead role. To this decline in interest rates corresponds a rise in asset prices, with strong credit growth boosting domestic demand during the adjustment process.

In summary, cyclical divergences during the 1990s occurred primarily between Germany on the one hand and former EMS-satellite countries on the other. These developments were inevitable only in the sense and to the extent that the deutschmark had been undervalued prior to the ERM crises and Germany bound to lose its former (key currency) interest-rate bonus with the launch of the common currency. Until that time Germany was perfectly free to compensate for these factors though. In particular, there was nothing to stop the relevant German authorities from conducting less inappropriate macroeconomic policies. For one thing, the Bundesbank was still in charge of German monetary policy and charged with a German mandate. For another, it was quite unnecessary to inflict a fiscal contraction upon Germany that lacked any historical parallel in the developed world. Behind all this was a deliberate abstention on the part of Germany's key authorities to address the problem of protracted domestic demand stagnation. Since the 1980s a peculiar "structuralist" (or, "supply-side-only") view is running high in German policymaking circles.

In the event, having lost both its former competitive advantages during the run-up to EMU, the DM undervaluation that had been accumulated during the hard EMS era as well as its traditional (key currency) interest-rate bonus, Germany was in poor shape to cope with the Asian and Russian crises that hit at the very time when Germany finally surrendered its monetary policy sovereignty too. It so happened that Germany became quickly dubbed the "sick man of the euro" when the new currency started on its steep decline in 1999 in view of a perceived growth disadvantage compared to the roaring United States economy. In retrospect, one is truly taken



aback by the degree of ineptness that characterized the German authorities' macro policy response to the unification challenge by means of which the Western German economy has been lastingly derailed – until today (Bibow 2005).

### **3. AFTER BRIEFLY ABATING EARLY ON, DIVERGENCE HAS QUICKLY RE-EMERGED WITH PROTRACTED STAGNATION SINCE THE 2001 DOWNTURN**

Between two long spans of subdued growth or near stagnation Germany actually experienced a brief burst of growth, starting in mid 1999 and lasting for a bit over a year. After the export slump of 1998-99, exports recovered strongly, amplified by the euro's plunge. Moreover, as fiscal consolidation briefly paused domestic demand growth accelerated to an annual rate of 2.5 percent in 1999–2000, so that real GDP growth reached a remarkable 3.5 percent pace in 2000.

Unfortunately, however, the euro's plunge also magnified the rise in oil prices and lifted import prices more generally, which pushed headline HICP inflation above the ECB's declared two-percent ceiling by mid 2000. Importantly, while the strength of these price effects differed significantly across Europe, core inflation remained very low and showed relatively little dispersion at the time.

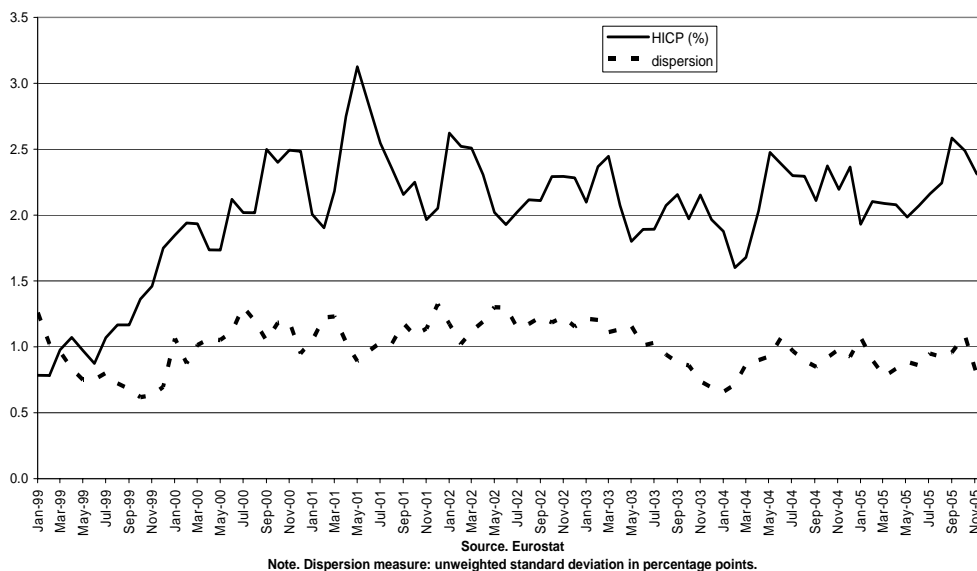
Things have changed again with the return of subdued growth since 2001, as, for instance, a report prepared in 2003 by the Monetary Policy Committee of the Eurosystem observed that:

“With the exception of Luxembourg, Belgium and Finland, all countries have experienced inflation persistently above or below the euro area average since 1999 ... A related issue is that differences in the evolution of inflation among the three largest euro area countries appear to have increasingly diverged since 2002. Despite the common slowdown in economic activity experienced by France, Italy and Germany, and notwithstanding the relatively similar cyclical positions of the latter two countries, inflation in core HICP components in Germany declined throughout 2002, whereas it was more or less flat in France and increased in Italy” (ECB 2003, p. 7).

It is of great interest that this report refers to a “common slowdown in economic activity” and to core rather than headline inflation. For the issue is barely discernable from the evolution of the dispersion in headline inflation across all euro area countries shown in Figure 1. Measured by the (unweighted) standard deviation of the ECB's

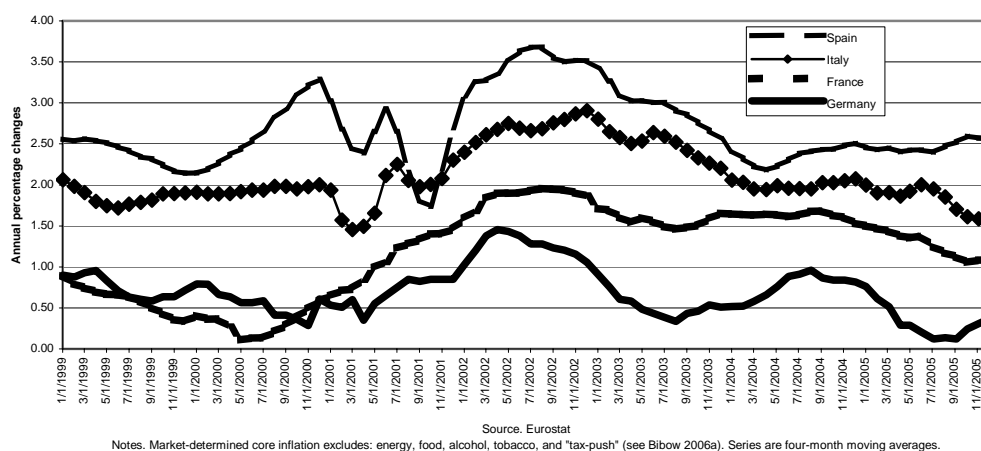
chosen inflation index, dispersion has stayed fairly stable throughout.

**Figure 1. HICP inflation since 1999: level up, but dispersion stable**



Yet, as the above report suggests and Figure 2 confirms, persistent inflation differentials have characterized developments in core prices in the largest eurozone economies. Spain was added to the analysis here despite not being fully comparable with “the big three,” given its remaining scope for catch up with the core countries in terms of income levels. Spain may be even less comparable with the smaller eurozone economies though, for which the argument developed here applies less fully.

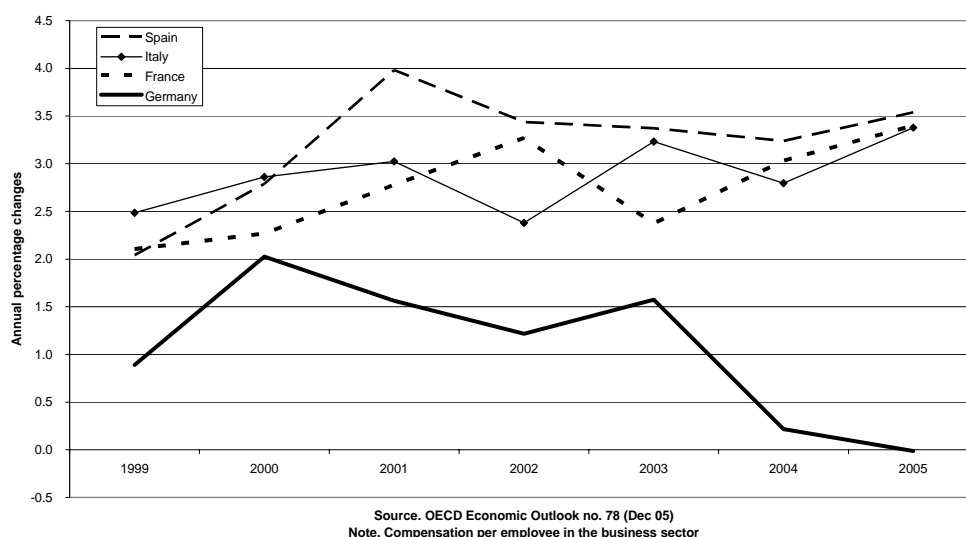
**Figure 2. Persistent differentials in market-determined core inflation (big four)**



The key feature emerging from Figure 2 is the decline in German (market-determined)<sup>1</sup> core inflation to close to zero, while price trends in the other countries have been running at significantly higher levels until today.

The underlying reason for this divergence in core inflation can be seen in Figure 3, which shows that German wage inflation declined to zero by 2005, with annual rates between 2.5-3.5 percent for the other three countries. This is a rather crucial fact in view of the proposition that flexible wages and prices can and should provide a key adjustment mechanism in EMU; to be discussed further below.

Figure 3. Diverging wage inflation trends, with Germany as the outlier

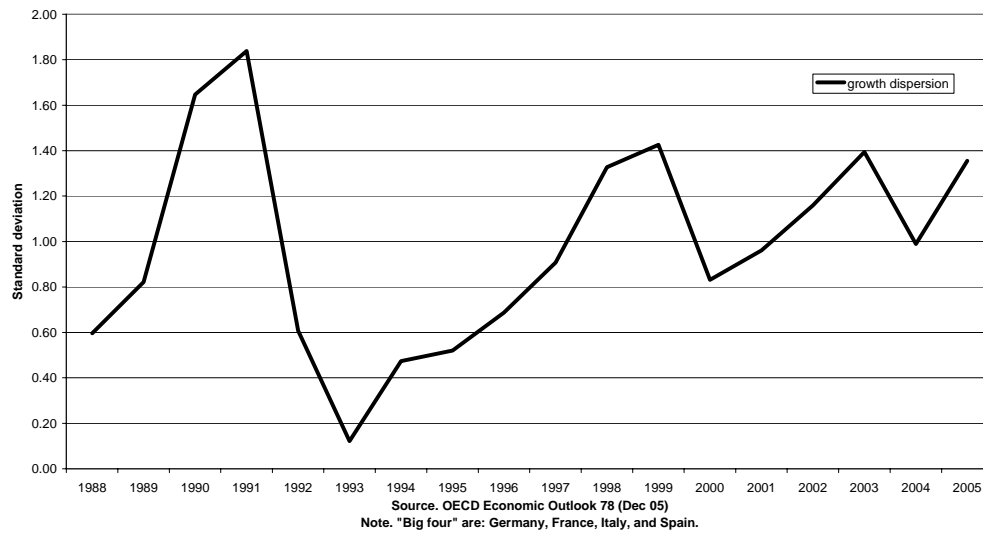


Turning to real divergence, the evolution of the dispersion of real GDP growth rates for the four largest eurozone members since 1988 provides a summary indicator. Figure 4 confirms that economies were severely out-of-sync around German unification in 1990. The subsequent decline in growth dispersion in the first half of the 1990s reflected the common recession of 1993 and the subdued growth that followed. The supposed convergence process then saw a sharp rise in dispersion in the second half of the 1990s, driven by those forces of divergence discussed further above. This trend was only reversed after the start of EMU with the brief common

<sup>1</sup> Apart from energy, food, alcohol and tobacco, this measure of core inflation also excludes the (approximated) price effects of “tax-push,” i.e., hikes in indirect taxes and administered prices. See Bibow 2006a.

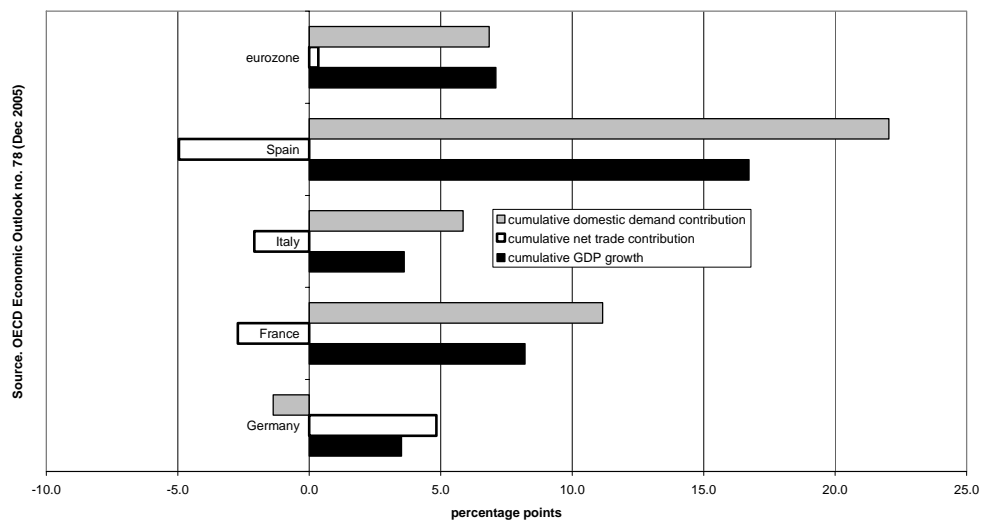
boom in 2000. Since 2001, however, real divergence is on the rise again.

Figure 4. Dispersion in big four's GDP growth rates since 1988



The overall magnitude of real divergence at issue here is reflected in Figure 5, showing the cumulative GDP growth differentials since 2001 as well as the respective cumulative net trade contributions to GDP growth over this period. While Spain's superior performance may partly reflect catch up, this case can hardly be made for France growing so much faster than Germany and Italy. As to the composition of GDP growth, note that Germany's growth over this period was driven more than exclusively by foreign trade! This is another crucial fact in view of the proposition that flexible wages and prices should provide the key adjustment mechanism in EMU.

Figure 5. Cumulative GDP growth and its composition (2001-2005)



#### **4. REVISITING OPTIMUM CURRENCY AREA (OCA) THEORY**

The issue of persistent divergence is important to EMU since member states have surrendered their ability to use national monetary and exchange rate policies to deal with it individually, while the common “one-size-fits-all” policy stance decided for them as a group actually becomes ever less fitting the more they drift apart. Worst, if such drift became self-reinforcing. Best, if automatic market mechanisms alone re-equilibrated the system. For the sustainability of EMU it is a vital matter whether market forces alone can be relied upon as drivers of supposedly equilibrating adjustment processes, or what role deliberate policies might have to play in all this.

Traditionally, this issue has been at the very heart of “optimum currency area” theory (OCA). Starting in the context of the fixed-versus-flexible-exchange-rates debate of the 1960s, OCA has identified certain properties that members of a currency union should possess to make the union function in a sustainable fashion. The central idea is that the more these properties were shared by all members, the more this would tend to reduce the need and usefulness of nominal exchange rate adjustments in achieving internal and external balance; namely, by reducing the likelihood and impact of certain types of shocks and/or in facilitating adjustment thereafter. On the basis of OCA, what was to be expected for Euroland?

Mundell’s (1961) starting point was that real world economies might lack the degree of price and wage flexibility which neoclassical theory postulates would assure a quick convergence back toward equilibrium, following shocks. The kind of shocks Mundell focussed on were asymmetric demand shocks, with demand shifting away from the products of one country towards those of another. Notice here that overall aggregate demand in the two countries together is not the issue. Rather, whereas one country suffers from a slump, the other experiences overheating. With wages and prices falling in the former while rising in the latter, or at least the relative pace of wage and price changes diverging appropriately, competitiveness of the two countries would adjust in ways that tend to restore both full employment as well as external equilibrium in both countries, and in a mutually beneficial way too.

As alternative adjustment mechanisms and criteria for evaluating the fitness for currency union membership, Mundell and later contributors to OCA emphasized: factor mobility, fiscal policy, diversified industry structures, openness and trade relations, and financial integration. All along, the key question was how useful and

effective national exchange rate and monetary policies might be in the event of asymmetric shocks, given certain properties of the economies involved. More recently, the idea has gained ground that the rather static OCA perspective on the matter may be misleading if establishing a monetary union itself tends to align countries more closely together in relevant respects, so that “optimality” of currency areas features important elements of endogeneity. As a summary measure of OCA wisdom (or, “meta-criterion”), business cycle synchronicity comes top.<sup>2</sup>

At least until recently, in applying OCA to EMU in Europe, there was never any question that wage and price flexibility might ever be sufficient to assure short-run stabilization. And, arguably, no real world economy really fulfils what seems to be required along these lines anyway; leaving aside for the moment Keynes’s (1936) fundamental reservations against this supposed route of macroeconomic adjustment. Instead, labor mobility featured most prominently as a potential alternative, although empirical studies always found Europe lagging the United States in this respect.

Be that as it may, given that the EU features “cohesion” and “solidarity” among its long-term goals, and uses regional policies to prevent regions from falling further behind, it would seem that large-scale permanent migration is not desired in the EU anyway. Moreover, as to the more relevant short-run too, labor mobility can hardly play more than a fairly limited role, given the immense costs involved in temporarily resettling families across the continent.

Mobility of capital in the form of real capital investment, on the other hand, has never really been seen as a major adjustment mechanism. Packing up factory plants and shuffling them across the continent is an unlikely event, especially for cyclical reasons. Similarly, running down existing real capital in one place, while starting afresh elsewhere, does not look like a viable strategy for short-run adjustment either. This is especially so as depressed regions are rarely seen as the location to be by Greenfield investors. Also, while overcapacities and depressed sales and profit expectations would, if anything, seem to work against the depressed region’s attractiveness anyway, financing cost may not be any lower there than elsewhere in the monetary union either.

Things may be different as far as cross-border mergers and acquisitions are concerned, since at sale prices troubled local firms in depressed regions might become

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<sup>2</sup> See De Grauwe and Mongelli 2005 for an overview of OCA.

attractive targets for foreign predators. That national authorities may be tempted to resist such penetration is one thing. More importantly, the key question is whether extensive M&A activities can really be expected to be conducive to stabilization in the short run – given the large-scale labor shedding and manifold frictions often involved in such scenarios.

This leaves mobility of financial capital. And in this area a fairly advanced state of financial integration may be attested across Europe with respect to both financial intermediaries and markets. Whether the current degree of financial integration may be sufficient to deliver much in the form of risk diversification and insurance across the union, and whether this can be reasonably expected to be more than a minor factor anyway, is one thing. But certainly the financing of soaring intra-union (current account) imbalances has not yet met any resistance in the financial system. The real issue is to what extent the financial system plays any equilibrating role or merely facilitates growing divergences, or perhaps even accentuates them.

Prior to the start of EMU some observers stressed the potential disciplining role of financial markets as far as public finances are concerned; with market discipline thus seen as a force that may be conducive to securing convergence and long-run equilibrium. In practice, with the disappearance of currency risk, sovereign credit spreads too have shrunk to very low levels over recent years and only few people seem to really expect markets to play any disciplining role at all today. In my view, this whole issue pertains to private financial relations within the union just as much, if not more, than to any exposure to public debt.

Yet, given a common monetary policy stance, to what extent can the financial system be expected to play any stabilizing role, tightening financial conditions in booming countries, easing them in depressed ones? To my mind it is not clear that finance necessarily plays any equilibrating role at all. It even seems possible that the financial system might actually amplify divergence apart from facilitating imbalances. Today, external imbalances within the eurozone feature both depressed countries (Portugal) as well as booming ones (Spain) with large current account deficit positions. And the same holds on the surplus side, with Germany and Ireland as prominent examples.

That leaves us with fiscal policy, stressed by OCA as the key policy instrument. The point is though that there is no proper fiscal policy possible at the union level as the current degree of fiscal integration is miniscule. Reflecting the

hybrid state of political integration, budgets and hence fiscal policy remain under national sovereignty. In fact, Goodhart (1998) argues that standard OCA analysis fails to appreciate the fundamental “link between political sovereignty and fiscal authority on the one hand and money creation ... on the other,” emphasizing that EMU in Europe represents an “unprecedented divorce between the main monetary and fiscal authorities” (p. 3) – with possible side-effects yet to be acknowledged.

In principle, fiscal policy is the only traditional stabilization policy tool left to members of EMU. Remarkably, the Maastricht regime’s designers foresaw neither any need to coordinate national fiscal policies, so as to assure an appropriate aggregate fiscal stance, nor to establish coordination with other policy areas so as to assure an appropriate mix of policies at any time. German policy wisdom suggested that policy responsibilities be kept clearly separate and monetary policy independent from any political control and accountability at all costs.<sup>3</sup>

While predictably detrimental for aggregate stability in the union, one might at first even see some virtue in this non-coordination as far as the flexibility of national fiscal policies in coping with the key OCA concern of asymmetric shocks and business cycle asynchronicity across the union is concerned. In practice, however, EMU in Europe was designed primarily with a view of disciplining national fiscal policies, which gave rise to the institutionalized fiscal straightjacket erroneously labelled “Stability and Growth Pact.” While the idea was to establish a more or less automatic, rule-based fiscal regime that relies on the free working of built-in fiscal stabilizers only, this pact is unlikely to deliver on either stability or growth.

Some of the most serious flaws in this dysfunctional fiscal regime stem from the unwarranted presumptions that the supposed budgetary equilibrium (i.e. a budget that is in balance or surplus) has already been achieved at the outset and that adverse conditions would never be severe enough to actually trigger the procyclical discretionary measures that breaching the three-percent deficit limit legally calls for.

In the event, EMU started with an aggregate budget position that fell well short of its supposed equilibrium position.<sup>4</sup> The slowdown of 2001 and protracted stagnation that followed then provided the very kind of adverse conditions which the

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<sup>3</sup> On the design of the Maastricht regime and critiques thereof see: Allsopp and Vines 1998, Bibow 2001, Dyson and Featherstone 1999, and Tietmeyer 1991.

<sup>4</sup> And contrary to popularly held beliefs, this was not due to insufficient ambitiousness in the run-up to EMU, but subdued GDP growth; which itself was at least partly the result of the counterproductive approach to fiscal consolidation followed during the 1990s.



pact was not designed to cope with. After quickly exhausting the rather limited fiscal leeway available according to the rules, procyclical discretionary consolidation attempts characterized the true working of the “Instability and Stagnation Pact” (Bibow 2001), further destabilizing the respective countries and the eurozone.

Arguably, this situation arose because the only stabilization policy instrument fully available in the eurozone, monetary policy, failed to stem the plight. Although Horst Koehler was merely spelling out textbook wisdom, it is worthwhile to recall here the IMF Chairman’s reminder issued to the ECB in 2002 that “monetary policy [was] the first line of defence”. Remarkably, ECB president Duisenberg responded that “he had never heard of that” (WSJE 2002).

In summary, it was quite clear from the start what is and what is not to be expected in the eurozone in terms of OCA adjustment mechanisms. And in view of actual developments since 1999 there have not been any real surprises at this front either. What is surprising, then, is that the thoroughly disillusioning experiences with the working of the ill-designed Maastricht regime have given rise to a remarkably hypocritical defense against the regime’s urgently needed reform. Today, and quite in conflict with the previous OCA focus, official doctrine is to put all the emphasis on the supposedly self-equilibrating role of wage and price flexibility; to be augmented not by demand-side (stabilization) policies, but supply-side (structural) reforms of market institutions that enhance allegedly lacking market “flexibility.” The supposed flexibility ideal Euroland is aiming for may not exist anywhere on this planet. But hypocrisy and denial still prevent a sober assessment of the fact that the United States and UK, for instance, use demand management policies to stabilize their respective economies.

The next section analyzes whether the peculiarly one-sided policy approach favored in Euroland due to German power might not only fail to deliver stability and growth, but could actually foster divergence at the same time as well.

## **5. ALL BETS ON THE “COMPETITIVENESS CHANNEL”: EXPLAINING DIVERGENCE AS CAUSED BY THE WORKING OF THE MAASTRICHT REGIME**

The proposition that wage and price flexibility, accompanied by structural reforms that further enhance the flexible working of product and labor markets, play a key role

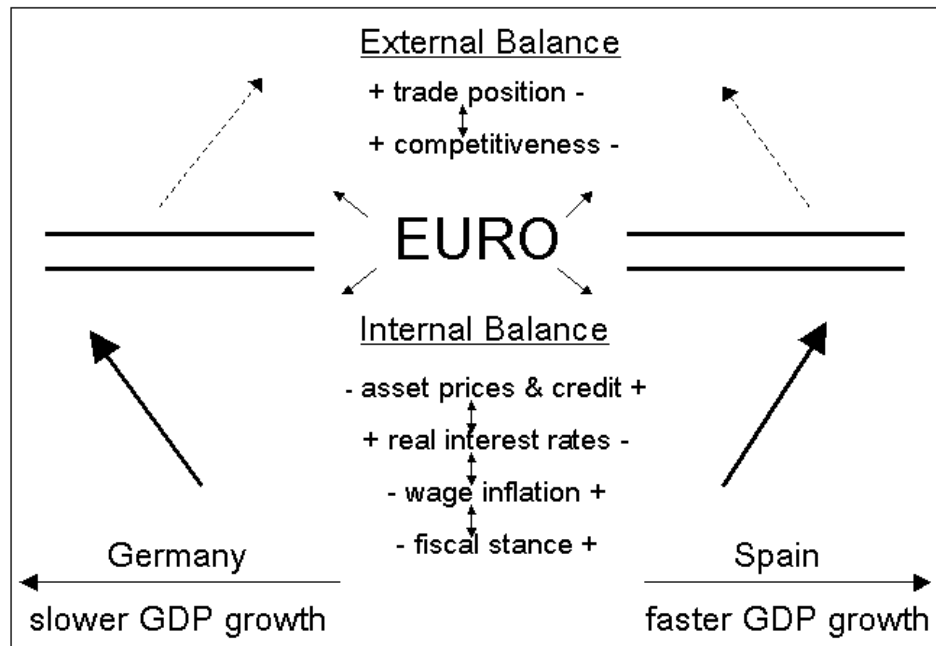
in fostering convergence and the smooth functioning of EMU was most clearly expressed by the ECB in the quotation in the introductory section above. The ECB refers there to inflation differentials as a “desirable” product of an “equilibrating adjustment process” within a monetary union (cf. ECB 2005, May Bulletin, p. 61). And, as an institution supposedly charged with the allegedly purely technical task of monetary policy that appears to justify its political independence, the ECB never tires of calling for reforms eliminating structural inefficiencies that allegedly give rise to undesirable inflation differentials.

A vital implication is that adjustment to shocks is supposed to work primarily through changes in competitiveness, featuring net exports as a key pull or drag factor on GDP growth. Indeed, the ECB is very optimistic on the effectiveness of this supposed equilibrating adjustment mechanism, asserting that the “competitiveness (‘real exchange rate’) channel, although slow to build up, eventually becomes the dominating adjustment factor” (ECB 2005, May Bulletin, p. 77). Similarly, the OECD (2004; emphasis added) observed that “in the absence of monetary policy instruments, and with the leeway for fiscal policy also limited, adjustment *will have to* relay on changes in external competitiveness *operating through wages and prices.*”

The “there-is-no-alternative” claim is always easily made. But developments since 2001 have provided an interesting experiment along these lines. It is thus appropriate to scrutinize the outcomes. Certainly wage and price developments between Germany and Spain have moved in accordance with the above proposition. Wage and (core) price inflation have fallen to historically low levels in stagnant Germany, but stayed at well above eurozone average levels in booming Spain, with France falling somewhere in between as regards both inflation and growth performance and Italy as something of an outlier (featuring *relatively* high wage and price inflation despite even worse performance than Germany since 2004).

The idea is that these developments would tend to drive diverging eurozone countries back to their converging steady-state growth paths. Alas, it is overlooked that important forces of divergence are also at work that actually amplify rather than counterbalance growth and inflation divergences. These are summarized in Figure 6, contrasting stagnant Germany and booming Spain.

**Figure 6. Partners drifting apart until ...**



Given the budgetary consequences of protracted stagnation versus protracted boom conditions, the SGP's inherent asymmetry provides a first important amplifier. For in booming Spain the SGP does not provide any effective discipline at all. In fact, Spain can even employ its favorable budgetary position to further stimulate domestic demand.<sup>5</sup> In depressed Germany, by contrast, the deflationary bias in the SGP springs to life as stagnation leads to a breach of the three-percent deficit limit (or threatens to do so), triggering procyclical *discretionary* consolidation attempts.

Further forces of divergence feature wages and prices themselves. Although diverging in their supposed way, the hoped-for equilibrating adjustment role of flexible wages and prices actually amplifies cyclical divergence at the domestic front, both directly and indirectly. To begin with, solid wage growth (apart from labor market strength and job security) directly bolsters private consumption in the booming economy, whereas wage moderation (apart from labor market weakness and widespread job fears) by depressing disposable incomes of wage earners further undermines private consumption in the depressed economy. In this context,

<sup>5</sup> In fact, Spain's finance minister Pedro Solbes plans tax cuts for 2007 in the order of magnitude of 0.5 percent of GDP – the “magic number” the same man asked “SGP sinners” like stagnant Germany to at least impose on their economies in his previous life as EU Commissioner. See Financial Times Deutschland 25 January 2006.

proponents of structural reform are quick to assert that positive confidence effects can easily do the trick and boost growth overall (just as positive confidence effects are routinely asserted for fiscal contractions and the ECB's notorious refusal to easy policy). Reality may not comply though. As to labor market reforms, too, German experience since 2001 points clearly in the opposite direction.

At the same time, wage trends are a most powerful force behind inflation trends, with further indirect effects. An important factor is that diverging inflation trends in a monetary union with common nominal interest rates imply that real interest rates can be highest exactly in those countries with already weak economies. The real interest rate differentials resulting from a "one-size-fits-all" monetary policy stance when flexible wages and prices adjust in their supposedly equilibrating ways thereby become another force of divergence. The OCA literature features the competitiveness channel in reversing the impact of demand-shift shocks, but overlooks the interest rate channel operating on domestic demand. The more important is domestic as opposed to external demand for the economy at hand, the more powerful this force of divergence, too. As a rule, the larger and less open the economy, the harder it will be to operate against these domestic forces. This is why we concentrate on larger economies here. The forces of divergence are also at work in smaller ones, but can be more easily overturned by a net exports boost.

Yet, real interest rate differentials are not really the end of the monetary story, but the origin of further amplifying factors inherent in the financial system. Relatively low real interest rates in buoyant economies with strong domestic demand will tend to attract willing (corporate and household) borrowers as well as willing lenders, nourishing credit growth and rising asset prices in self-reinforcing ways. By contrast, relatively high real interest rates in stagnant economies can arouse the exact opposite kind of financial propagation mechanisms in stagnant economies – providing yet another important source of divergence.

Perhaps the most crucial insight is that these various forces of divergence do not operate independently, but reinforce each other. For in each country they all operate in one and the same direction. As a result, partners continue drifting apart and may get ever further away from re-attaining a balanced position, both individually and as a union. Focusing on the internal balance issue up to this point, the analysis will now turn to the external part of the supposedly equilibrating adjustment process since external imbalances are bound to arise in the process too.

## **6. INTRA EURO AREA IMBALANCES SOAR AS MISDIAGNOSIS AND FLAWED ADVICE HOLD SWAY**

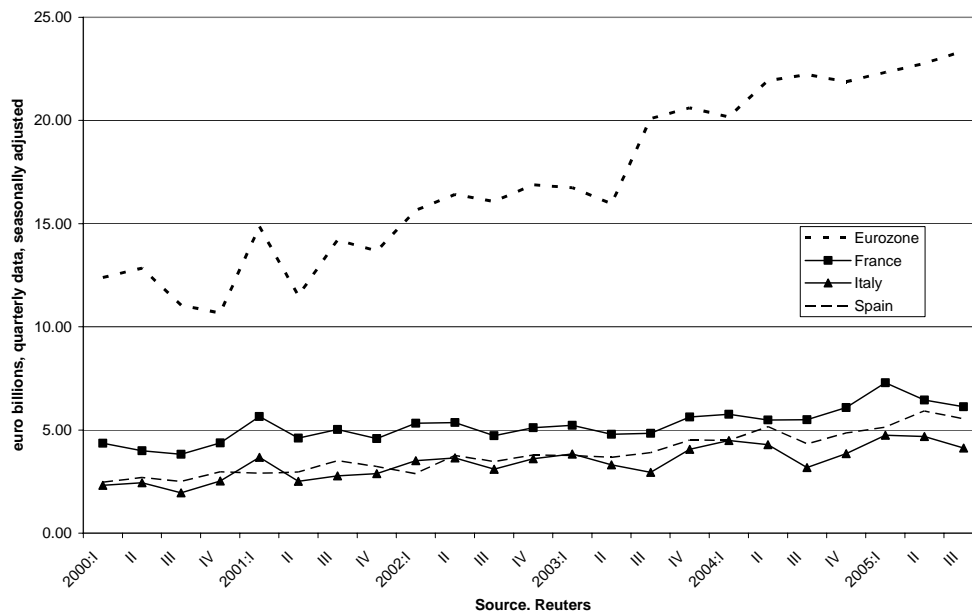
To be sure, diverging wage and price developments are key driving forces behind changes in competitiveness and over time impact on trade positions accordingly. The ECB (2005) asserts that the competitiveness channel “eventually becomes the dominant factor.” The problem is that blind reliance on the competitiveness channel alone may not only be ineffective (or worse) in fostering internal balance in the short run, i.e. over the cycle, but is causing lasting divergences and the build-up of external imbalances too. Especially in large economies reliance on the competitiveness channel comes at the price of depressing domestic demand through the various operative channels analyzed above. A liberalized and integrated financial system can facilitate and accommodate growing (intra-union) “external imbalances” for a long time without prompting any self-equilibrating forces. Worse, procyclical propagation mechanisms inherent in the financial system can even be a continuing force of divergence – up to a point.

In section 4 above I emphasized that Germany’s GDP growth since 2001 derived (more than) exclusively from net trade.<sup>6</sup> In Spain, by contrast, net trade has been a persistent sizeable drag on GDP growth, while France and Italy have seen their net trade shift from contributor to drag on growth since 1999. Germany’s current account surplus is forecast to climb towards 5 percent of GDP this year. The absolute swing in its current account balance since 2000 amounts to some \$140bn – the largest swing in any surplus country in the world. This is not only highly relevant in the context of global imbalances, as a good part of the swing in Germany’s trade balance occurred within the eurozone – at the detriment of Germany’s European partners.

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<sup>6</sup> And to the extent that business investment has picked up since 2004 this is concentrated in the export-oriented sectors too (Loose and Ludwig 2005). Internally, Germany’s beggar-thy-neighbor policies have created a truly dual economy together with a heavily shifting income distribution.

Figure 7. Germany's growing trade surpluses with its partners



In other words, while Germany's reliance on the competitiveness channel may have backfired internally by depressing its domestic economy, up to this point it has clearly worked externally, namely by passing on the buck to those partners that have been less negligent with respect to their domestic economies, like France and Italy, for instance. And in this way, Germany's beggar-thy-neighbour strategy can work towards convergence, eventually. But convergence toward a depressed level of activity it will be if Germany's weakening partners respond to the rising external drag by deflating their economies too; convergence through spreading the German disease.

Clearly this strategy is self-defeating for the union as a whole and it is thus quite astonishing that the euro's supposed guardians should find so much praise for Germany's pursuits. Essentially, Germany pursues a beggar-thy-neighbor competitive devaluation – a strategy that the euro was meant to ban forever.<sup>7</sup>

Interestingly, the external drag has so far failed to derail Spain's decade-long boom. Spain's current account deficit is forecast to reach double-digit territory by next year. A good part of this deficit is with Spain's partners in the Euro area, where

<sup>7</sup> A popular – albeit thoroughly confused – view holds that Italy, in particular, still has to go through the wage deflation Germany has already accomplished (see Bibow 2006b). While a deutschmark revaluation is clearly not an option any more, note that internal balance could also be restored by raising the German wage level accordingly – which highlights that German corporate profits are at issue. Neither course will do anything to address the aggregate demand deficiency in the eurozone.

current account imbalances allegedly do not matter any more. Yet, do not overlook that with Spain's public budget roughly in balance an important implication is that Spain's fast deteriorating international investment position is driven by private sector financial deficits of corresponding magnitude.

True, some part of this imbalance may have its counterpart in Germans acquiring vacation domiciles in Spain. And another part is in the form of equity flows which supposedly serve as an equilibrating mechanism within the union. But especially the private debt structures involved, which represent the bulk of Spain's external imbalance, imply a corresponding rise in foreign exposures to rising debt levels and asset prices in Spain. This raises the risk of contagion through the financial system in case of an asset price slump and debt crisis that may seem local at first.

In this context, it is worthwhile to recall the unresolved lender-of-last-resort issue in Euroland. This issue, in turn, is inherently related to the "unprecedented divorce between the main monetary and fiscal authorities" in Euroland emphasized by Goodhart (1998, p. 3). This is not to suggest that Spain is the only eurozone country where property market developments, in particular, have given rise to some concern. In fact, there are other examples where asset price developments seem to have decoupled from the real economy. And there are of course examples among the new EU members with even larger external imbalances. But Spain is of particular interest: with foreign exposures to private credit risks in Spain soaring, the competitiveness channel is predicted to "eventually become the dominating adjustment factor" (ECB 2005) – while the nominal exchange rate can play no part in all this!

In summary, sole reliance on the competitiveness channel, that is, on wage-price flexibility as well as structural reforms intended to enhance their flexibility, ignores important forces of divergence that tend to depress domestic demand in the deflating country. In addition, to the extent that the deflating country's competitiveness actually improves, export success will come through spreading its problems to trading partners. These will get dragged down through deteriorating export performance and likely experience a build-up of external imbalances; which will unravel at some point.<sup>8</sup>

The two key flaws in Europe's official flexibility doctrine featuring wage-price flexibility and the competitiveness channel may thus be pinpointed. One is to

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<sup>8</sup> Nonetheless many observers today appear to be even surprised that the "eurozone fails to match Germany's revival" (FT.com, 1 February 2006).

ignore Keynes's chapter 19 insight that wage flexibility essentially means monetary policy conducted by the trade unions. The other is to ignore that Mundell focused on the competitiveness channel specifically in the context of asymmetric shocks.

As to the first flaw, recall Keynes's conclusion in chapter 19 that money wage flexibility may be both less effective as well as riskier than stable wage inflation combined with deliberate stabilizing monetary policies by a competent central bank. The point is that downward wage flexibility effectively works through forcing expansionary monetary policy upon the central bank; apart from whatever net exports this strategy might elicit through the competitiveness channel. The trouble is that this may not work for a large economy with a slow central bank, either because the economy slips into deflation before the central bank dares to act or because factors other than wages keep up inflation and thereby forestall monetary easing.

The latter case best describes developments in the eurozone as a whole. The budgetary consequences of stagnation led to a sizeable upward distortion in headline inflation as finance ministers raised indirect taxes and administered prices in view of their ongoing struggle with the SGP. Bibow (2006a) identified the resulting "tax-push" inflation as a symptom of ill-guided macroeconomic policies that have caused macroeconomic fragility in the eurozone as a whole. The value added of the analysis in this paper was to investigate the forces of divergence at work when a large member country like Germany follows the flexibility prescription. The point is that the competitiveness channel is not the only channel at work and that in large economies the overall effect may be to destabilize the deflating economy, apart from spreading domestic problems to partners and causing divergences within the union.

As to the second flaw, do not miss that Mundell's OCA was about *asymmetric* shocks that resulted in demand imbalances while overall effective demand was not deficient. Under such circumstances, it is true that the playing out of the forces of divergence highlighted in the above analysis may be an inevitable part of any re-adjustment. So a vital point is that the "2001 global slowdown" was first of all in the nature of a common shock, a shock which therefore required a common response boosting depressed overall demand. Reliance on the competitiveness channel under such circumstances does not at all foster any mutually beneficial rebalancing of overall demand, but represents a beggar-thy-neighbor policy plain and simple; only that the policy's intricate workings may not be so plain and simple, owing to the



complex forces of divergence involved in the process.<sup>9</sup> *It was only through the working of these forces of divergence within the framework of the Maastricht regime that the originally symmetric shock attained its asymmetric characteristics as well.*

## 7. CONCLUDING OBSERVATIONS AND PROPOSALS FOR REFORM

The analysis in this paper has identified important forces of divergence that are inherent in the working of the Maastricht regime of EMU. Featuring the supposedly equilibrating role of wage-price flexibility, it is shown that detrimental effects are to be expected both for larger countries relying on their working and the union as a whole. The official flexibility doctrine therefore offers misguided advice in stressing the role of the competitiveness channel in rebalancing divergences in economic activity and inflation, as experienced across the eurozone since 2001. Official advice ignores fundamental insights of Keynes and Mundell.

For the eurozone as a whole Keynes taught us that downward wage flexibility can only work through inducing timely and well-measured monetary easing; which is anathema to the “stability-oriented” mindset and approach ruling at the ECB. Otherwise this strategy is a risky one as it can lead to either stagflation (as occurred since 2001) or even outright deflation. For a large economy like Germany’s, for instance, downward wage-price flexibility triggers powerful adverse domestic channels that can for long over-compensate the competitiveness channel, fostering fragility as well as divergence and the build-up of imbalances along the way.

No less important is the fact that Mundell stressed the competitiveness channel as rebalancing two countries that were hit by an *asymmetric* shock. By contrast, when the “2001 global slowdown” hit the eurozone, this was originally a symmetric or common shock that required a common policy response – which was not forthcoming. This policy failure occurred due to crucial flaws in the Maastricht regime – a failure that cannot be rectified by then relying on the competitiveness channel instead. For in case of symmetric shocks the working of the competitiveness channel will not be of a mutually beneficial kind at all, but represent beggar-thy-neighbor instead. This is a

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<sup>9</sup> Whereas Mundell (1961) focused on asymmetric (demand-shift) shocks, Friedman’s (1953) case for flexible exchange rates was inspired by the idea that this would free macroeconomic policymaking to focus on internal balance; following Keynes (1923) of course. By contrast, the Maastricht regime is about apparent macroeconomic policy abstention – a thoroughly fallacious idea indeed.

recipe not for rebalancing, but for undermining the euro. It is invoking what EMU was supposed to ban forever – competitive devaluations.

It thus reflects flawed thinking to assume that structural reforms are the answer to the current situation and to assert that a more flexible eurozone economy might cope better with the same kind of shocks next time round. Union-wide downward wage flexibility raises the risk of deflation, a sure recipe for disaster in conjunction with a slow-to-ease central bank. If downward wage flexibility in Germany alone were enhanced, the above analyzed forces might work faster – albeit with unclear ramifications! – but the beggar-thy-neighbor character of the strategy would not change. At best, enhanced two-way [sic!] wage-price flexibility might speed up the rebalancing of countries through the competitiveness channel in a mutually beneficial way in response to properly *asymmetric* shocks of the demand-shift type, although the forces of divergence operative within the Maastricht regime that were identified above remain relevant even then.

The bottom line is that micro flexibility is no substitute for proper aggregate demand management and structural reform of markets no substitute for reforming the flawed Maastricht regime of EMU. The Maastricht regime fosters divergence as well as fragility. The latter problem arises because no one is keeping the domestic demand store – unless the ECB chooses to do so. And the former problem is bound to even worsen with and reinforce aggregate fragility, especially in case of ill-guided reliance on the competitiveness channel as a substitute for appropriately designed policies addressing, as the case may be, common shocks and/or asymmetric shocks and divergences.

Apart from the macroeconomic policy regime reforms I suggested elsewhere (Bibow 2003), I recommend that wage inflation in the larger economies need to be aligned, both for their own good as well as in view of the sustainability of EMU. By coordinated effort a stable long-run (4-5 percent) trend of wage inflation should be established, with persistent divergences in productivity trends and external imbalances justifying deviations from the established wage norm. For smaller countries the situation is somewhat different because in their case (due to a greater degree of openness) the competitiveness channel might dominate the domestic channel (with its

inherent forces of divergence) even in the short run.<sup>10</sup> Yet, while wage-price flexibility can thus play a stabilizing role in their case, there should be safeguards in place against using this route in a free-riding way, that is, at the expense of partners. Again, external positions might provide guidance on tolerated deviations from the wage norm.

Finally, since throughout the analysis it was largely ignored that the eurozone is part of an increasingly integrated global economy, let me add here that it is not advisable for the world's second largest economic area to rely on the competitiveness channel (vis-à-vis the rest of the world) as its growth engine. Especially in view of mounting global imbalances this is a high-risk strategy (Kregel 1999).

Luckily, since 2003 and until today a very favorable global environment has helped to offset the Maastricht regime's deflationary bias. Arguably, Germany has been the greatest beneficiary of all – the export world champion whose trade surplus dwarfs that of China. The real test will only come when Germany and the eurozone can no longer freeloader on external stimuli. A serious risk is that a United States slowdown will prompt U.S. dollar weakness. And it is true that a rising euro together with falling oil prices can have a strongly deflationary impact. Whether their deflationary impact will boost domestic demand sufficiently to offset the external demand weakening that is likely to trigger these events, as some seem to hope, remains to be seen though.

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<sup>10</sup> The “Dutch miracle” of the 1980s and 90s is a case in point here; a miracle ending in boom and bust though as the bigger neighbor retaliated by wage deflation. See also Fritzsche et al. 1999 and Hein and Truger 2005.

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