EMU – What Role for European Central Bank in the asymmetric shocks?

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Abstract:
The consequences of exogenous shocks hitting either the supply or the demand side, some of them affecting European Monetary Union (EMU) area, are labeled “common” or “symmetric”, while the others - hitting only a part of countries - are labeled “idiosyncratic” or “asymmetric”. EU Member States agreed to share a common single currency. EMU was achieved in three stages through coordinating economic policy, achieving economic convergence, sharing a common currency – Euro.

The first stage was achieved from 1 July 1990 to 31 December 1993 (exchange control abolished, capital movements liberalized, Maastricht Treaty convergence criteria), while the second was between 1994, January, 1 and 1998, December, 31 (establishment of European Monetary Institute, adoption SGP and ERM II), and finally, the third came into force from 1 January 1999 (ECB establishment for leading all monetary policies in the common monetary area, Euro adoption).

Keywords: asymmetric shocks, convergence, capital movements, technocracy, expertise.

I. Introductory Consideration.

The asymmetric shocks are better described with the OCA (Optimal Currency Area) theory which was enunciated firstly by Robert Mundell (1961) [1] proving to be an useful and very popular economic instrument.

Analyzing the potential gains and losses for Canada in joining to a monetary union with US, OCA stated a number of criteria for an optimal currency union, describing the economy as following a path - the long-run potential growth path – which is mainly determined by supply-side factors uninfluenced by macroeconomic policies. The fluctuations around this path are the consequences of exogenous shocks hitting either the supply or the demand side, some of them affecting European Monetary Union (EMU) area, being labeled “common” or “symmetric”, while the others - hitting only a part of countries - are labeled “idiosyncratic” or “asymmetric”.

But, what is EMU? EMU is a “core Europe” through which some EU Member States agreed to share a common single currency. EMU was achieved in three stages through coordinating economic policy, achieving economic convergence, sharing a common currency – Euro.

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The monetary union could be better described in its dynamics using the ALIS schema applied to (neo)functionalist theory.[2]

II. (Neo)functionalist theory.

These scholars offer an explanation how to solve the individual and transnational problems through technical cooperation, which is built from bottom-up using the forms that trespass the formal sovereignty reducing the states' ability to act as sovereign entities in different sectors. Its preference towards step-by-step method of integration (real but limited transfer of sovereignty) supported the idea of a “core Europe” in which some willing and able states could start an enforced cooperation in a certain sector being opened to gradual integration of other states at the moment when they are prepared. The Eurozone is an example of such “core Europe”.

1. The (neo)functionalism’ assumptions are based on the positive view concerning human nature, being in line with John Locke and or John Stuart Mill tradition, assuming the human nature as good and optimistic. Cooperation could evolve even between rational egoists in order to fulfill better their needs.

Functionalism’ assumptions transferred to the European level could be translated in the next rationale: if human beings can cooperate rationally to fulfill certain common needs, the same could do the EU Member States.

According to these assumptions, EMU is a consequence of positive-sum-game, understood as being the cooperation in the mutual advantage of its members, in order to fulfill jointly their needs in monetary area.

2. The idea of “form follows function” is the central point of (neo)functionalism. As such, the logics of European monetary system mean that the most ‘functional’ (most efficient) institutions such as ECB could be set in order to support the best solution to
the problems in monetary sector (form follows function) because the cooperation needs to be located on the adequate level (the cooperation on an adequate level could be considered as the origin of the EU’s subsidiarity principle).

According to (neo)functionalism, the successful cooperation in one sector would trigger the further cooperation in another sector (spill-over effect or sachlogik). As such, EMU is the result of spillover effect of common market achieving and the “technical” policy-making process. The ERM success and Single Market completion required imperatively the collaboration in monetary area in order to maximize their benefits. From collaboration within ERM, the significant monetary policy convergence was arising.

In this process (spill-over or sachlogik), supranational actors and institutions, such as European Central Bank (ECB) proved to be influential. They are providers of expertise in order to achieve collective outcomes through sectorial cases of functional cooperation and mutual dependence (peace in parts).

3. Functionalist institutions must reflect the logics of “technocracy” and “expertise” such as we already showed. In this regard, ECB was endowed with the both technocracy and expertise.

Actually, concerning the role of institutions, neo-functionalism considered them as being the central agents in organizing the integrated sector, and to push further the integration process shifting the loyalties, not only by elites – who are considered as being a crucial part in establishing the working peace setting – but the popular loyalties, too. Therefore, in neo-functionalist theory, institutions could also be political (elites are central parts) as well as providers of expertise (in this point, neo-functionalism is different by the classic functionalism). Following this logic, some European politicians tried to politicize ECB without success.

We will focus in this paper especially towards European Central Bank (ECB) competences to define monetary policy for Eurozone in order to implement it uniformly. Its main aim is to maintain price stability and, consequently, a low inflation. ECB takes care by foreign reserves of ESCB, is competent to conduct foreign exchange operations, etc being structured in: a body called Governing Council with decision-making attributions in monetary policies, interests’ rate, etc; an executive body which implement
Governing Council decisions being called the Executive Board; and a plenary organ, respective, the General Council.

Because ECB coordinates entire monetary policy within EMU, the next arguments concerning the strategies available for monetary union could be realized only with ECB support.

4. The strategies in functionalist theory were displayed along the two key variables: widening and deepening. We will focus only upon the strategies and remedies to asymmetric shocks existing already for the actual EMU members because they will be available also for the new members. In the sense of, institutional deepening cooperation within a group of „willing“ and „able“ member states, such as Eurozone is, must take into account the national interests, especially, of the states affected by asymmetries within EMU.

The strategies of adjustments to asymmetric shocks were better described by OCA theory (at least, for federal states).

Concerning the asymmetric shocks, we will show, for the first, the channels of adjustments available for federations and unitary states in order to analyze in so far such instruments are available at EU level and the path following towards a European centralized economic government.

Symmetry

OCA Theory

EMU

Federal States

Economic Governance

Flexibility
Commentary: In this picture, on the vertical axis, we set out the degree of shocks’ symmetry, while on the horizontal axis we have the degree of flexibility. In this diagram, Economic Centralized Governance and federal (or unitary) states are able to use the labor market flexibility, interest rates, exchange rate more, because they have the most flexible policies in order to face the asymmetric shocks, while the EMU is the most rigid but, also, with a big degree of symmetry.

In a federal state, the first channels of adjustments to asymmetric shocks would concern the labor market mechanisms: unemployment rising, wages downwards, out-migration which will alleviate the unemployment effects. From this point of view, wage or labor flexibility is low in the EU. Therefore, ECB and European Commission asked EU Members to pay attention to the problems of flexible wages and “structural reforms” in the sense of labor markets flexibility.[3]

However, the most important channels of adjustment for a federation are financial instruments. These instruments would use the parity change. In addition, a country has to borrow from abroad in order to keep budgetary deficit under control and to smooth consumption and investment paths. Its central budget is also an important instrument used for reducing the amount of taxes collected and increasing a number of relevant and useful social expenditures for solving crisis, such as unemployment compensations.

Are these channels available for EMU? In any case, the European budget is too inelastic and too small for making adjustments in the face of asymmetric exogenous shocks.

When a country joins EMU, it loses its ability to use monetary and exchange rate policy for its economy stabilising. Therefore, some scholars defended the idea that it is the best if Governors Council allows EMU Member States some autonomy completed with some forms of co-ordination in national fiscal policies or to create an insurance fund. The same, it could allow Eurozone countries to negotiate their deficit.

These theses were rejected on the grounds that the public budgetary deficit and debt of one country from Eurozone would hit the budget of the others in the logic of spill-over effect within monetary union.

Concerning the use of financial instruments for crisis prevention, the market corrections showed the necessity of the EU surveillance and financial regulation of
national central banks and fiscal policies. The European supervisors’ committee could reinforce trans-border cooperation and information exchange in order to avoid the asymmetries of information. In this process of EU financial surveillance and regulation, the Council of Governors could play an important role. It could be essential to exploit further the Lamfalussy framework in accordance with ECOFIN Council guidelines.

III. The McDougall - Delors Report.

This Report tried to solve the capacities of Eurozone to face the asymmetric shocks dealing with the problem of reducing disparities in *per capita* income through the process of equalising and stabilising using EMU mechanisms. In this regard, fiscal policies under EMU would involve a set of net fiscal transfers towards countries affected by crisis for stabilising rather than redistributing wealth. In their view, such transfers could use a certain percent of funds destined to structural adjustments.[4]

Complementing some national provisions, the EU tax system could lead to automatic transfers among regions. Giving such redistributive functions to an EU tax system would avoid the discussions concerning such transfers at the national level. These discussions will be moved, rather, towards how much redistribution should occur across countries, than to economic national policies. Though this common tax system could not be achieved easier, it is more and more probably that political pressures requiring such redistribution and the spill-over effects of the Single Market and the EMU itself, may lead to such system of European taxes in the future.

There were also some debates concerning the savings coming from the reduction in interest rates relying whether and how the ECB will use these resources.

Another option in order to face asymmetric shocks within Eurozone would be, such as we showed, to allow the Member States to increase their budgetary deficit and debts within EMU. It is well-known how many pressures and difficulties were raised in the case of Central-Eastern Member States in order to maintain the minimum level of public deficit and debt required by the Stability and Growth Pact (SGP) or Maastricht criteria in order to join Euro area. Arguing the necessity to modify or renounce to the aforementioned documents, Mundell-Fleming theory highlighted that the effectiveness of a monetary union is dependent by the efficiency of the various domestic policies which
would lead to the necessity of more autonomy for national fiscal policies. The question remained: in how far such autonomy has to be given? The same, it is still unclear the question in how far the link between EMU and the national fiscal policies is consistent with this fiscal autonomy. Whatever, the Maastricht or SGP criteria are seen more and more as being obsolete for the new European realities.

To support the aforementioned, Robson suggested in his book entitled “The Economics of International Integration”, that the optimal level of stabilization in EMU is not necessarily tied with the concentration of stabilization of functions.[5] The weakness of Keynesian point of view concerning the autonomy of fiscal policies (only fiscal stimulus in the form of deficit spending could allow to face with unemployment rate and resources) is whether the fiscal discipline within EMU could be affected by unsustainable debts of some Member States which will be propagated by spill-over effect within EMU. Some strategies for keeping fiscal discipline called upon the imposition of certain rigid ex-ante limits of public deficits and debts or some forms of fiscal surveillance of national fiscal policies in order that they have to rely with the EU policy objectives.

From a contrary point of view, some scholars reported the federal fiscal system of US to that of EMU considering that the European economic governance more centralized would be necessary. This theory dealt with a stronger political and economic dimension of the EMU. The main focal point is the balance of competences between EU and Member States. In order to implement the centralization of national economic policies at EU level, it would be necessary an European Government with the economic powers to tax and spend. It could provide also ex-ante limits for other economic policies which are, for the moment, in the competences of national states. In some views, this European economic govern could be the ECB, while other scenarios concerned ECOFIN.

IV. Conclusions.

In few words, we will remember that there are still critics concerning the monetary union creation, so, it is still far until an European Govern endowed with economic policies to be viable.
Keynesian or post-Keynesian economists criticized EMU coordinated by ECB in the sense that only fiscal stimulus in the form of deficit spending could allow to face with unemployment rate and enforce the state ability to command resources. Even with some structural changes, these economists deemed that to share a common currency has more disadvantages in spending than the advantage of reducing the transaction costs (even, in asymmetries reducing).

On the contrary, the Mundell-Flemming model argued that it is impossible to maintain a fixed exchange rate, free movement of capitals and an independent monetary policy in the same time. Therefore, these three elements were called Mundell-Flemming trilemmas. Mundell-Flemming opted-out for exchange rate and interest rate flexibilities and, also, governmental expenditure adjustments. It seems that their opinion found real express in the actual context of Fiscal Treaty in which the disparities between North and South European countries increased.

REFERENCES: