Georg M. Busch

Georg M. Busch
Head of Unit
European Commission,
Directorate-General for Economic and Financial Affairs[1]

Comments on Andrew Hughes Hallett, Svend E. Hougaard Jensen and Christian Richter, "The European Economy at the Cross Roads: Structural Reforms, Fiscal Constraints, and the Lisbon Agenda"

Professor Andrew Hughes Hallett (AHH) has presented an interesting paper in which he deals essentially with three issues: monetary union and its possible enlargement; structural reform; and budgetary discipline. These are indeed topical issues in the EU and beyond, and further insight into their determinants and inter-relations are needed and most

[1] *This contribution reflects the personal view of the discussant only and in no way implies the European Commission or its services. I am indebted to H. Jansen, S. Kuhnert and P. Ritter from DG ECFIN for valuable comments and suggestions. The usual disclaimer applies.*

welcome. The analysis of AHH and his co-authors derives from Bayoumi's well-known paper of 1994 on optimal currency areas. That analysis is now being carried further and extended by bringing in the dimension of structural reform. Indeed, the authors present a model that tries to capture the relative costs and benefits of possible accession candidates and incumbents of a monetary union which differ in their level of structural flexibility/rigidity. What is most interesting, though, is that by doing so, Bayoumi's earlier conclusions on the incentives of "ins" and "outs" for enlarging a currency union are turned upside down. Further work is probably needed in order to integrate the other two aspects into a consistent model framework. Thus, the relationship between structural reform and fiscal discipline and its empirical verification is partially treated outside the model. Also, the issue of enlargement of EMU to the new Member States is referred to only briefly, without being further elaborated.

The paper investigates into three propositions:

1. A flexible economy will find it unattractive to join/remain in a union of economies whose markets are relatively unreformed or rigid;
2. The requirement of fiscal discipline acts as an impediment to structural reform;
3. Structural reforms are hindered by the fact that they typically involve large costs up front or in the short run, and only bring benefits in the longer term.

I shall briefly refer to the model presented for the first proposition, before dealing with the propositions themselves.

The Model

AHH's model is an adapted and extended version of a model first suggested by Bayoumi (1994), a general equilibrium model of optimal currency areas. As Bayoumi, AHH assumes downward nominal wage rigidity. The basic effect works as follows. If a country is hit by a negative productivity shock, the nominal wage rate cannot adjust downwards. However, a floating exchange rate can insulate the labour market to retain full employment at lower output. The loss to all trading partners is the loss in output from the productivity shock. With a fixed exchange rate between two countries, their common external exchange rate moves only partially to a negative shock in one country. This implies that the nominal wage rigidity partially translates into unemployment and thus output loss that exceeds the productivity shock. As each country produces a unique good, the assumed preference structure ensures that this additional output loss affects all countries, even those outside the currency union. As a further distinction between countries, AHH introduces differential "economic flexibility" in countries in- and outside the union.

It is understood that "flexibility" in the AHH paper is confined to the aspect of downward adjustment of nominal wages. The assumed wage rigidity assumed for the members of the currency union translates into quantitative adjustments in the labour markets which in that regard are assumed fully flexible. The model does thus not deal with those kinds of reform that address, for example, hiring and firing rigidities. As far as employment beyond the full employment of the domestic labour force is concerned, there is a further rigidity: countries cannot absorb all of the immigration pressure. This rigidity, however, may not necessarily be linked to the functioning of the labour market, but possibly to output capacity constraints. Furthermore, the immigration absorption parameter is reinterpreted as "fiscal flexibility", understood as large fiscal multipliers and minimal restraints on the budget. This limits the possible scope of economic reforms that the paper is able to address.

What is noteworthy, is that by introducing differential degrees of structural flexibility, a central conclusion of Bayoumi is turned upside down. As one may recall, Bayoumi found that a currency union raises welfare of "ins", but lowers welfare of "outs", because "outs" partake in the costs (due to interaction between common exchange rate and nominal rigidity) but not in benefits (lower transaction cost). Therefore, a small "out" will always have a greater incentive to join than the union will have to admit the new entrant. With AHH, this incentives mismatch goes the other way round: a more flexible "out" will have less incentive to join a more rigid union than the union has to admit a more flexible member.

This brings me to AHH's first proposition:

"A flexible economy will find it unattractive to be in a union of economies whose markets are relatively unreformed or rigid."[2]

However, as the proposition goes on, *"the more rigid economies will want the flexible economy to join. This incentive pattern reduces the chances of market reform, encouraging a general move towards rigidity. It further creates a distinction, in terms of membership, between rigid existing EMU countries, flexible Northern and less flexible Eastern economies."*

I have some doubts here about the inferred implications of "flexibility" versus "inflexibility". Thus, in the case of excess demand: will price/wage rises really be higher in the more flexible economies, reliev-

ing the more rigid ones of some excessive demand pressure, as it is claimed? I am not sure, since in the "more flexible" economies, labour supply may be more flexible as well and thus more responsive to higher wages.

Conversely, in the case of deficient demand: Will rising unemployment in the rigid countries spill over to the flexible ones and drive wages down disproportionately there? Probably not, as in the "rigid" labour markets, outward migration of the unemployed will *ex definitione* be low.

Unlike with Bayoumi (1994), the issue large versus small region is totally ignored in the context of the "rigid" EMU versus a "flexible" outsider (UK). This also holds true for the abolition of transaction costs which is largely to the benefit of the "small" adherent.

[2] *Quotations in this contribution refer to a draft version of AHH et al. "The European Economy at the Cross Roads: Structural Reforms, Fiscal Constraints, and the Lisbon Agenda."*

Therefore, systematic free-riding by the "rigid" from the "flexible" economies seems to me unlikely.

Finally, in the line of reasoning (Bayoumi, 1994, AHH et al., 2004) on the relative costs and benefits of joining versus staying out of EMU, it is not quite clear whether the "costs" from a monetary union are due to the lack of the exchange rate or to the inflexibility that is being transmitted via external demand. In principle, the "outs" should remain totally isolated via their still flexible exchange rates.

In that context: the caveats against the model specification to which Bayoumi (1994) pointed, are no longer highlighted. Thus, a currency union may provide welfare gains also to "outs" via an increase in potential output inside the union (e.g. economies of scale, improved resource allocation from abolition of transaction services) or lower transaction costs even outside the union.

Looking at things from the empirical angle, the semantics of "flexibility" become important. There is considerable variation inside EMU in the degree of different dimensions of flexibility between members. As far as nominal wage rigidity is concerned, this is generally not considered to be the most severe problem, when compared with other kinds of rigidities in the institutional or regulatory framework. More generally, while there is certainly slow progress in structural reform, a "race to the bottom" is hardly observable.

The interesting issue of EMU enlargement to the new Member States of Eastern Europe is raised in the present paper, but not further developed.

The second proposition goes:

"The requirement of fiscal discipline acts as an impediment to structural reform."

The central argument here is that *"reforms cost money. Too tight a set of fiscal controls – i.e. the Stability Pact – combined with market rigidities will cause a conflict, by slowing down growth in the short term and increasing deficit spending during the reform period. Conversely, large rigidities would make structural deficits larger and again reforms less likely."*

Here, AHH applies the same argument of external spillovers and "expectations mismatch" as for the former case of rigidities. *"Fiscal restriction in one country will impose costs on all others, by increasing the amount of adjustment that needs to be undertaken to restore equilibrium within each of those countries"*. Thus, each country in a monetary union will be tempted to "free-ride", wanting its partners to apply a greater (or at least the same) degree of fiscal flexibility than itself.

The two key premises in this reasoning are that

– reforms entail substantial short-term budgetary costs, and
– governments are hindered to incur those costs by the fiscal rules.

I want to challenge both arguments.

First, those very reforms that are intended to do away with structural rigidities, i.e. introduce greater wage flexibility and increase labour mobility would hardly lead to higher cost and indeed, should improve the budgetary position already in the short term. I am thinking of cuts in subsidies across-the-board, trimming welfare benefits in order to "make work pay" and raise incentives for hiring and taking up work.

Second, no government that has come into conflict with the Stability and Growth Pact has done so because of the cost of the sweeping reforms it has introduced. The authors themselves claim that fiscal flexibility "can overcome the consequences of rigidities" – therefore, should the pressure for reforms not increase when there is a *limit to* fiscal flexibility? Moreover, to attribute fiscal inflexibility entirely to the Stability and Growth Pact is too narrow a view: It may be as well be self-inflicted: A country that bases its budgetary planning on unrealistic baseline scenarios is bound to find its fiscal room for manoeuvre reduced ex post. The reasons for fiscal inflexibility are rather the lack of reforms and budgetary slippage in "good times". It is not the fiscal rules or the budgetary costs that make governments shy away from taking the necessary reforms – it is the political costs they fear.

Contrary to the argument of the paper, the Pact should be seen as a catalyst for structural reform, by providing a budget constraint without which such reform would be put off even further.

Proposition three claims:

"Structural reforms are hindered by the fact that they typically involve large costs up front or in the short run, and only bring benefits in the longer term. Politically sensitive policy makers may then worry that the short-term costs will outweigh the longer-term benefits – especially if the latter are rather uncertain."

My reservations about the alleged large short-term costs of structural reform apply here as well. If this were so, why should structural reform then be so unpopular and difficult to implement, if it involved a short-term large budgetary burden, i.e. the government spending extra money or foregoing revenues? Surely, short-sighted politicians and their (probably equally myopic) voters would love just that! If, however, even the longer-term benefits are "rather uncertain", then the question arises why we would need structural reform at all.

At this stage, there is a break in the paper's analysis. The empirical verification is not based on the model previously presented – in fact, the model does not incorporate

a short- versus long-term dimension – but using the Oxford Economic Forecasting (OEF) model.

For example, the simulation part claims an alleged "adjustment burden" to the UK when joining an "inflexible" core EMU in terms of higher (wage) inflation in good times and higher unemployment or falling wages in bad times (section 4). It is not clear to me how this relates to the theoretical model presented. After all, relieving other countries of adjustment pressure was shown to be beneficial to all countries in the model.

Furthermore, the "negative spillover effect onto Britain" from joining EMU identified in section 5.2 does not seem to be related to the model either. In the model, spillovers arise also to non-members and cannot be done away by independent monetary policy.

Section 6.2 on structural reform in Germany is also unrelated to the theoretical part, insofar as nominal rigidities are not addressed. Furthermore, potentially interesting findings are not explained. For example, what is the reason behind a reduction in employees' social security contributions having a small effect on the economy while reducing employers' contributions having a larger one?

Thus, the "empirical verification" of the theoretical hypotheses presented, does not appear entirely convincing and the "results" presented are to some extent subject to arbitrariness and "belief". ❧

References:

Bayoumi, T. (1994). A Formal Model of Optimal Currency Areas. In: IMF Staff Papers 44. 537–554.

Hughes Hallett, A. and S. E. H. Jensen. 2004. On the Enlargement of Currency Unions: Incentives to Join and Incentives to Reform. In: Beetsma, R., C. Favero, A. Missale, V. A. Muscatelli, P. Natale and P. Tirelli (eds.). Monetary Policy, Fiscal Policies and Labour Markets – Macroeconomic Policy Making in the EMU. Cambridge University Press.