RELEVANCE OF THE OPTIMUM CURRENCY AREAS MODEL FOR THE PROCESS OF EUROPEAN MONETARY INTEGRATION WITHIN THE NEW CONTEXT OF CRISIS

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Rezumat

Pe parcursul timpului, zona euro s-a dovedit a fi o regiune experimentală, un model de analiză a procesului de integrare monetară şi deci un suport pentru dezvoltarea conceptului de zonă monetară optimă. Criza financiară şi economică globală, care s-a declanşat încă din anul 2007 şi care a schimbat peisajul integrării economice şi monetare în Europa, poate aduce noi observații cu privire la acest concept, poate întări sau reformula anumite criterii, această ipoteză fiind motivația realizării prezentului studiu.

Abstract

Over the time, the Euro area proved to be an experimental region, an analytical model for the process of monetary integration, therefore a support for the development of the concept of optimum currency area. The global financial and economic crisis which started in 2007 and which changed the landscape of the European economic and momentary union may bring new observations regarding this concept and may strengthen or reformulate specific criteria, reason why we conducted this study.

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The concept of “optimum monetary area” was formulated by Robert Mundell in his paper *„A Theory of Optimum Currency Areas”* published in the American Economic Review (1961). A whole range of ideas, concepts and problems originated from this notion and were presented in an extensive literature on the monetary integration.

Synthetically, the theory of optimum currency areas has six basic criteria which the states integrated in a monetary area must meet: three economic criteria, which actually form the traditional theory of the optimum monetary areas, and three political criteria, added subsequently as a consequence of the limits identified in time. The economic criteria (workforce mobility, level of reciprocal opening, diversification of the productive and commercial activity) shows that giving up the exchange rate criterion increased the costs due to the asymmetric shocks. The political criteria, regarding the fiscal transfers, the homogenous preferences of economic policy and the level of solidarity – added in time, are the result of the attempts to identify different mechanisms to handle the asymmetric shocks, on the background of the rigidities existing in economy: the fiscal transfers are a mechanism regulating the regional misbalances within a monetary union, while the homogeneity of preferences rather prevents the contradictory effects generated by specific or common shocks.

The criteria formulated in time are not normative, rather orientational, being hard to quantify[1]. Furthermore, the development of the concept started from hypotheses which proved to be interpretable (for instance, the regulating role of the independent macroeconomic policies on the economic misbalances, the long-term

[1] *For a presentation of the theoretical criteria formulated in time see Criste A., Theory of the Optimum Currency Areas – Implications for the Evolution of the Euro Area, Financial Studies, vol. 1 (39), Bucharest: CCFM, „Victor Slăvescu”, 2008.*

stable connection between inflation and unemployment or the stabilizing effect of a flexible exchange rate).

The euro zone is an experiment of the monetary integration. Its history of more than 10 years and the reactions of the euro zone member states within the context of the recent shocks may serve to knowing and understanding the underlying principles of an optimum currency area.

According to past research (OECD, 1999 and CE, 1999), the European countries are characterised by a **high level of price and wage rigidness and by low workforce mobility**. Flexibility is low in the European countries for the nominal and real wages (Calmfors, 2001), while the adjustment of the real wages to the economic shocks propagated throughout Europe is very slow (OECD, 1994). Workforce mobility is low in Europe not just between countries, but also within the individual countries. Besides the social and cultural motivations (differences of language, traditions, customs), there also are economic and institutional-administrative reasons: limited transferability across borders of the social protection and of the additional retirement rights, administrative difficulties and high dwelling costs, lack of comparability and reciprocal acknowledgement of the professional qualifications, employment restrictions in the public sector. A rather recent empirical study (Alesina, Ardagna, Galasso, 2010), which analyses the **impact of adopting the euro on the structural reforms** (flexibilization of the products and work) highlights the fact that some reform actions have been undertaken on the market of some products from the countries from this monetary area, but that the workforce market is still highly rigid. The **correlation of the economic cycles** between the member countries of a monetary area is a subsidiary criterion in the theory of the optimum currency areas presumed to be met as the economies are increasingly integrated. The existence of a long-term synchronization of the economic cycles between the member states of a currency area increases its optimality provided the decision of joint monetary policy is not obstructed by possible asymmetrical shocks. The evaluation of the correlation of the business cycles between the member countries of the Euro zone, made by Giannone, Lenza, Reichlin (2010), shows that there are no significant modifications of the path of the economic cycles from the adoption of the euro

compared to the previous situation, and divides the surveyed groups in two groups. The first group includes countries with a similar level of the GDP per capita (Germany, Austria, Belgium, the Netherlands, France, Italy), as of the early 1970 years; the second group includes countries with different levels of the economic activity and which generally are more volatile (Greece, Spain, Portugal, Ireland, Luxemburg, Finland). The survey reveals the constant synchronization between the economic cycles of the countries from the first group throughout the analysed period (1976-2006); the correlation of the economic cycles is weaker in the countries from the second group, feature which also existed before the adoption of the single European currency. These observations confirm the existence of the "centre-periphery" pattern of the Euro area and that the loss of flexibility of the exchange rate and of the monetary policy independence didn't affect the fluctuation of the economic activities between the countries, although the countries are heterogeneous in terms of competitiveness and real interest rates.

Differences in the pattern of economic growth (relying on the domestic consumption or on the foreign demand) have been noticed within the EMU, along the ten years and more of functioning, also reflected by the evolution of the macroeconomic indicators.

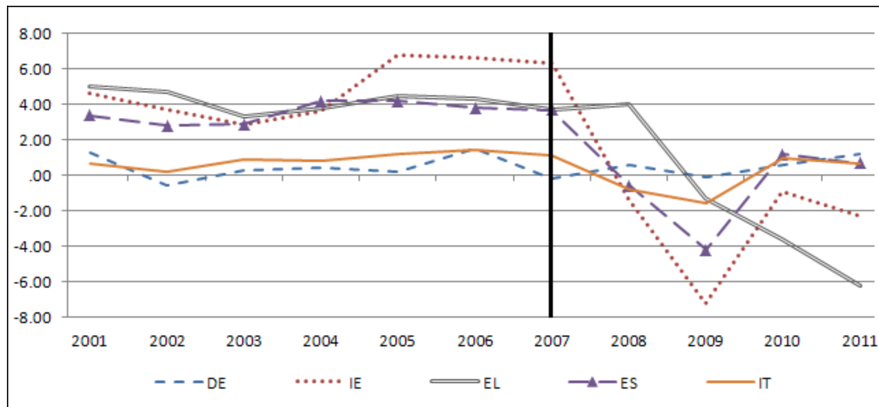
Before the onset of the global crisis, the world economy was marked by a general optimism, with a high level of global liquidity and with intensifications of the international flow of capital, including in the European countries. These phenomena stimulated the investment and crediting activities, to the detriment of saving, but in an asymmetrical manner in the countries from the euro zone, the peripheral countries developing mainly on the background of a **model of indebtedness**. Such development, doubled by the increase of the commercial and financial interdependence between the EU member states, also increased the risk of a possible blockage of debt financing, as it actually proved to be after the world financial and economic crisis broke out.

The incertitude of the investors manifested by the bankruptcy of the Lehman Brothers (shock of incertitude) determined a differentiated treatment of the debts of the countries from the euro zone. Thus, the investors oriented mainly towards the countries which were more macroeconomically stable and which had a better

institutional maturity (Germany). Such phenomenon affected the countries which had spectacular economic growth during the recent years (Spain, Ireland, Greece, Portugal): their economic growth slowed down and adverse effects appeared: higher unemployment rate, higher budget deficits and public debt, dramatic corrections of the current account balance of payment balance, as shown by the charts below

Chart no. 1

Evolution of the private consumption in some countries from the Euro zone (annual rate of increase) before and after the onset of the global crisis



DE - Germany; IE - Ireland; EL - Greece; ES - Spain; IT - Italy.
Source: Eurostat data

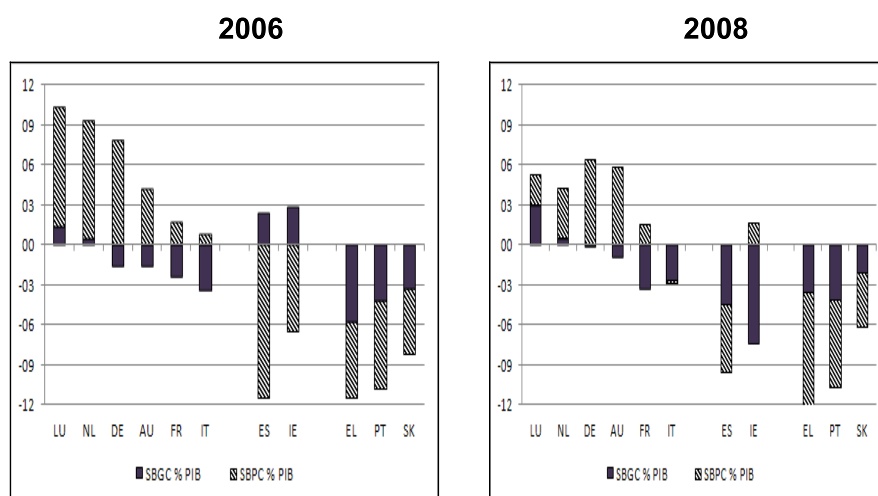
Chart 1 shows the differences between the countries from the euro zone in terms of the patterns of economic growth and the reaction of these countries to the global crisis. Thus, in 2001-2007, the private consumption, shown as annual rate of increase, was stronger in Spain, Ireland and Greece and much weaker in Germany, and Italy, the difference being obvious. On the other hand, in 2007-2009, while Germany and Italy maintained the rates of increase of the private consumption, the household and company consumption "crashed" in the other three countries due to the speculative bubbles (from the real estate and technological markets) and due to the build-

up of debts (enhanced crediting activity). After 2009, the private consumption bounced back in Spain and Ireland, while it continued to decrease in Greece. The contraction of the private consumption is also explained by the higher unemployment rate, mainly in Spain.

The fail to observe the “Pact of stability and growth” and the fail to take into consideration the level of indebtedness of the private sector developed into a drawback of the coordination at the euro zone level. The current crisis revealed the importance of this variable by the link it set between the current account balance and the balance of the consolidated general budget (see Chart 2).

Chart no.2

Situation of the consolidated general budget and of the budget of the private sector in some countries from the euro zone



SBGC – balance of the consolidated general budget; SBPC - „budgetary” balance of the private sector

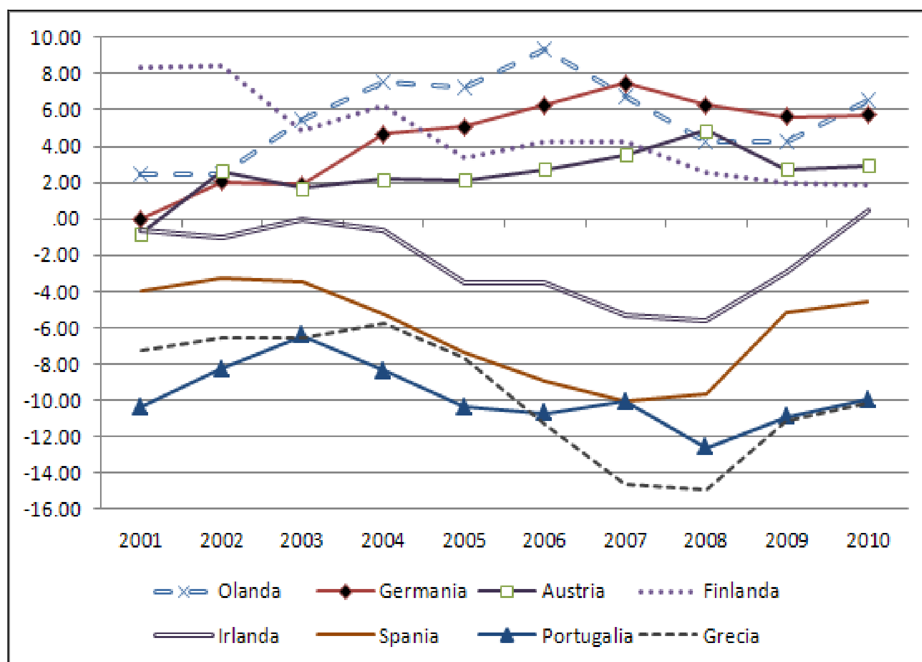
Source: Eurostat data

The analysis of the evolution of these variables reveals significant differences between the euro zone member states with significant misbalances in Spain, Greece, Portugal shown by current account deficits and important surpluses in Germany, the Netherlands and

Finland (Chart 3); both these situations show an external misbalance due to the different evolution of the demand components. On the one hand, in Spain, Greece or Portugal, the economic growth relied on the final consumption and on the development of investments in constructions, stimulating the imports. On the other hand, Germany followed a growth pattern based on export, deterring the private consumption.

Chart no.3

Evolution of the current account balance of the foreign payment balance in countries of the euro zone

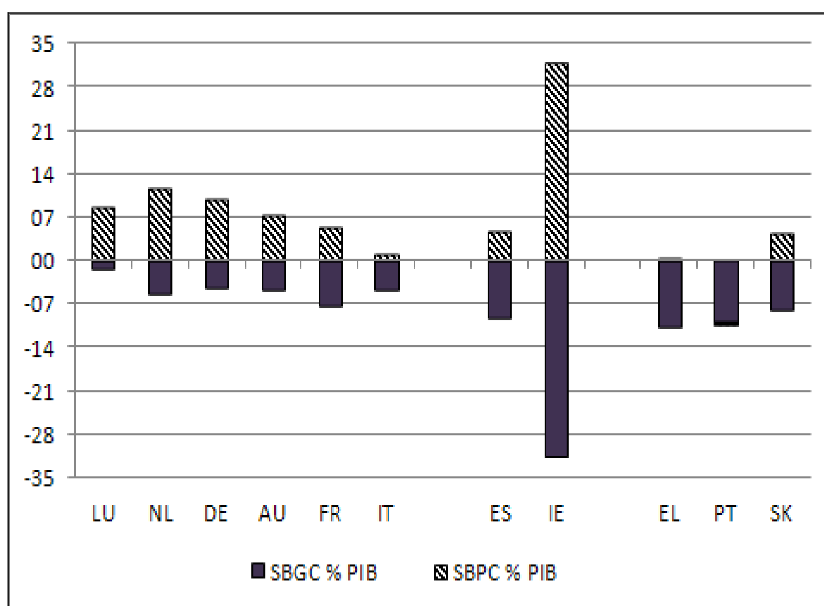


Source: Eurostat data

After the start of the economic crisis, the very strong correction of the current account balance of the foreign payment balance in Ireland was achieved by the accumulation of a significant surplus in the private sector (31.8% in 2010), while the deficit of the general consolidated budget was the highest of all European countries (31.3%), as shown in Chart 4.

Chart no.4

Situation of the consolidated general budget and of the balance of the private sector budget in some countries from the euro zone in 2010



SBGC – balance of the consolidated general budget; SBPC - „budgetary" balance of the private sector

LU - Luxemburg; NL - Netherlands; DE - Germany; AU - Austria; FR - France; IT - Italy; ES - Spain; IE - Ireland; EL - Greece; PT - Portugal; SK - Slovakia.

Source: Eurostat data, calculations by the author

The global financial crisis generated by the shock of mistrust has shown that the rules regarding the budget deficit and the public debt are not enough to avert the default of the euro zone member states, thus enabling a sustainable evolution of the euro zone. The crisis amplified not just the economic misbalances, but also the political dissentions. The disagreements between the two great European powers, Germany and France, were mostly visible about the method to solve the Greek situation. Germany favoured IMF intervention and

insisted initially to observe the *no bail-out* principle, while France was against IMF intervention and supported the establishment of a support fund to grant loans and guarantees to Greece, thus avoiding the phenomenon of contagion. The diverging opinions continue to exist between the large economies of the euro zone, which only aggravate the political situation of this union implicitly affecting its long-term operation.

An important element which influences the functioning of a monetary area is its **macroeconomic credibility and stability**.

According to Mongelli (2002), the fiscal integration presumes three conditions. The first one refers to the accomplishment of the fiscal convergence between the member countries of the monetary union. In the euro zone this condition means the accomplishment of the nominal fiscal-budgetary criteria stated by the two European treaties (the Maastricht Treaty and the "Pact of Stability and Growth"). Although some studies (De Bandt and Mongelli. 2000) noticed that from 1970 to 1990 the fiscal dispersion between the European countries decreased, this is no longer true after the adoption of the euro. As the statistic show, the differences between countries in terms of fiscal-budget position and public indebtedness are not only significant, but persist despite the process of economic integration, despite the fiscal-budgetary harmonization (including the fiscal-budgetary legislation). The second condition of the fiscal integration is the fiscal stabilization, with national budgets balanced or having surplus, with the purpose to use them as instruments for the absorption of the adverse shocks. Most countries from the euro zone not only don't have budget surpluses, but they don't even have balanced budgets. The Pact of Stability and Growth, which requires the observance of specific conditions with the very purpose to allow the euro zone member countries having balanced, even "positive" budgets, was often breached, thus compromising the capacity for national fiscal stability, yielding a poor capacity to use the fiscal instrument to absorb the adverse shocks. The "deficient" functioning of the national fiscal stabilizers thus claims the adoption of supranational mechanisms of absorption of the adverse shocks (fiscal transfers between countries, international distribution of the risk via the financial markets, change of the prices and wages or change of the real exchange rates). The third condition regards the capacity of

the currency area for the public distribution of the risk by way of a supranational budget. The latter condition presumes fiscal transfers between the member states depending on their necessities of financing. The euro zone has no own budget, and the EU budget accounts for less than 2% of the total GDP of the EU member states, being intended mainly to support the agricultural and environmental activities, job creation, cohesion and research activities. The amounts stipulated in EU budget are not used to absorb possible regional shocks. From this perspective, the euro area doesn't fit the criterion of the interregional fiscal transfers mentioned by the theory of the optimum currency areas; the lack of such instrument for regional stabilization makes it vulnerable to the potential asymmetrical shocks.

Roth, Nowak-Lehmann D. and Otter (2011), analysed, for EU-15 and EU-27 countries, therefore for the countries form the euro zone too, the relation between specific macroeconomic indicators (inflation, growth, unemployment, governmental debt) and the trust of citizens in the national and European political institutions, both before the onset of the financial crisis and during it. The authors noticed that unemployment caused a significant decrease of citizen trust in the European and national structures, particularly for the EU-15 member states (which can be associated to the euro zone), being stronger for the national structures. The increase of the public debt as proportion of the GDP decreased the trust during both periods, for both levels of the political governance. The analysis of the direct effects of the financial crisis confirms that the significant decline of the real economy (lower GDP per capita) was associated to a temporary increase of the trust of citizens in the national institutions, but the analysis of the entire period of crisis reveals a levelled image: this feeling of national association can be identified only for the national institutions, not for the European institutions. The trust in the European national and supranational institutions decreased to the historical levels in many European countries, particularly in the countries from the periphery of the euro zone which were most exposed to the financial crisis and to the crisis of the euro zone. Furthermore, Ireland, Spain, Greece and Portugal recorded significant increases of the unemployment rate (particularly Ireland and Spain) and sudden increases of the proportion of public debt within the GDP (particularly Greece and Portugal).

The authors conclude that the trust of citizens in the national European authorities during the period of crisis is strongly affected by the evolution of the unemployment rate and of the proportion of public debt within the GDP, particularly in the peripheral countries. They consider that the European national political authorities should first solve the crisis of the euro zone and assist the peripheral European countries to decrease the level of the public debt and increase the employment rate, and only afterwards hope to gain back the trust of their citizens. The decrease of the citizen trust in the national institutions is worrying by the effect it may generate: the increase of the long-term political costs in the euro zone. Focusing only on the way to avoid the risk of sovereign default in order to protect the European banking sector, the authorities from the euro zone (particularly the authorities leading this area – Germany and France) prejudiced severely the democratic and political stability in the peripheral countries (Ireland, Greece, Spain) (Roth, 2011).

The crisis of the sovereign debt in some countries from the euro zone is a consequence of the broken link between the two basic elements of the political authority in a state – the fiscal authority and the monetary authority, and this separation is a vulnerable element for such monetary union.

The studies of Willett (2004) and of Krugman and Obstfeld (2003), show that the euro zone is first of all an economic union, **not a political union**, which proves the existence of insufficient capacity to solve the internal misbalances within this union.

Conclusions

Although short, the history of the process of monetary integration in Europe reveals the weak fundamentals of this union, not just in terms of failing to meet some criteria revealed by the theory of the optimum currency areas, but also in terms of the vulnerable economic and political elements on which the construction was done, or which accumulated in time.

The idea of currency area optimum should be an element of reference for the functioning of the euro zone, but the concept needs revision on the basis of the specific conditions of the European monetary integration.

One of the important conditions for the optimal operation of a monetary union is the existence of a **stable domestic economic and political environment**, at least from the perspective of the decisions of the authorities governing that area. The existing regulations, specified by the Pact for Stability and Growth lost credibility because they were frequently transgressed, and because they are incomplete, ignoring the problem of the private debt and of the misbalances of the current account of the foreign payment balance.

A high level of **workforce flexibility**, criterion of the theory of the optimum currency areas, is theoretically and important instrument for the correction of the regional macroeconomic misbalances in the monetary zone, but actually it is difficult to evaluate and the rigidness of this element is many times the consequence of the governmental policies from the member states.

The experience gathered by the euro zone proves the **importance of the political factor** of its long-term functioning. Focusing exclusively on economic rules for the accession to the euro zone, such as those from Maastricht, or from the PSG, cannot support on the long term the functioning of the euro zone. Furthermore, the diverging opinions of the political authorities from the euro zone will fail the euro zone project and the optimization of its long-term operation.

The lack of shock-absorbing mechanisms such as a **system of fiscal transfers** between the member states with the purpose to support or rebalance the economies of countries or regions in difficulty continues to be a shortfall of this monetary union.

The **criterion of solidarity** mentioned by the theory of the optimum currency areas proves to be important during this period of crisis. However, its interpretation and application are difficult. Empirically, one can notice that the level of solidarity depends on the economic and political conjuncture: it is high during periods of optimism and low during periods of crisis and incertitude.

The research of this subject proves that the process of monetary unification has is meaningless without the permanent concern to optimise the monetary zone. The purpose of the euro zone is to have a competitive position on the international market and to support the development of the member states. If any of these objectives fails or is affected, then the euro zone cannot withstand on the long-term.

The current crisis is a survival test for the euro zone and an opportunity to rethink the optimisation of its long-term performance.

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