

The Euro and Structural Reforms

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This paper by A. Alesina, S. Ardegnà and V. Galano – in short AAG – is indeed a “triple A” contribution. It addresses an important aspect of EMU and brings together economics and political considerations to explain policy choices. The authors go the hard way of detailed empirical work, scrutinize a myriad of data and remain careful in their interpretation.

To start with, EMU in the end was a political decision. Economists around the world were more or less sceptical. Their fundamental concern was an obvious lack of flexibility in the economies of potential member states and as a consequence in the future monetary union. For example, on 9 February 1998, 155 German academic economists published an open letter entitled “The euro is coming too early” – the main reasons being lack of flexibility in labour markets (and insufficient progress in consolidating public finances).¹ And it was in the first weeks after the establishment of the ECB when I received a letter by Milton Friedman saying: “Dear Otmar, congratulations on an impossible job. You know I am convinced, monetary union in Europe is doomed to fail.”

In short, a clear majority of economists pointed to the fact that a monetary union with the envisaged large membership – 11 countries finally to start on 1 January 1999 – would be far from fulfilling the criteria of an Optimal Currency Area (OCA). But, the project of monetary union, the ambition to be allowed to participate, and after

¹ See already O. Issing, Europe: Political Union through common Money?, IEA Occ. Paper 98, 1996.

entry, the need to adapt to the new framework of a single monetary policy – “one size fits all” –, and the removal of the tool of national monetary policy and changes in the exchange rate of the national currency – strengthened structural reforms and fiscal consolidation.

The conditions for entry enshrined in the Maastricht Treaty– at least formally – referred only to nominal variables. The discipline exerted by these criteria in some cases came late, but all in all it was timely enough. The threat of not being in at the start of EMU unleashed unexpected forces, including the sphere of fiscal policy – admittedly with grave exemptions as regards public debt levels.²

But, what about structural reforms, progress towards greater flexibility in product and labour markets? The authors identify two layers of a potential impact of EMU.

One is (dis-)qualified as “wishful thinking”, the rhetoric that any step towards more integration is “by definition good and brings about all sort of wonderful achievements for the Continent, and therefore the adoption of the Euro was a good thing by definition”. Strange as it might sound for an economist this “philosophy” of integration or what it may be called played for some time an important political role under the label of the “monetarist” position. This was based on the expectation that once the exchange rate would be fixed irreversibly the “rest” would adjust in a mysterious way.

² O. Issing, *The Birth of the Euro*, Cambridge, 2008.

The other line of argument refers to the fact that monetary union eliminates the option of strategic devaluations, or more generally of adjusting policy rates to national cyclical conditions, and enforces therefore pressure for enhancing the flexibility of labour markets and wage bargaining.³

In this context AAG mention that not surprisingly initially the pre-Euro debate focused on labour market reforms. The effect on product markets comes mainly from increasing costs of regulation due to stronger competition.

To what extent are the criteria of OCA endogenous? What is the impact of EMU on concrete steps for more flexibility in product and labour market?

Here, the authors are confronted with a tremendous identification problem. AAG concentrate their empirical study at a one shot event – the introduction of the Euro. The difficulties to isolate this effect from the rest of the environment are obvious – and fully recognized by the authors:

1) The process of globalization has created incentives for reforms world-wide.

³ A few authors argued that the disappearance of the exchange rate risk would lead to a higher demand for protectionism and thereby weaken the incentives for structural reforms. See L. Calmfors (2001), Unemployment, labour market reforms and monetary union, *Journal of Labour Economics*, No. 19, pp. 265-289.

2) The introduction of the Euro is not just exogenous. Countries discussed pros and cons and adapted to the common currency for different reasons which could have effected also incentives for structural reforms.

3) The effect of the introduction of the Euro preceded the start of EMU. As soon as it became a common conviction that EMU would start as agreed in Maastricht on 1 January 1999 risk premia in foreign exchange markets started to decline and preparation for participation reached a decisive phase.

4) The observation period still is rather short –further impact might be in the pipeline.

5) Finally, and most important: Is it possible to disentangle the effect of participation in the single market from the introduction of the Euro?

The main result of their empirical study can be summarized in two sentences:

1) The adoption of the Euro had a significant effect in promoting the adoption of product market reform especially in some sectors. Here one is tempted to argue that the impact should rather be in general terms i.e. comprise structural reforms on a broad macro level. So, are sectoral reforms more due to sectoral specifics than to the introduction of the Euro?

2) For labour market reform the Euro did not have much of an effect. Here one may caution a bit. For example, the euro may have contributed to the major labour market reforms which were implemented in Germany in 2004 and early 2005.

The authors are also convinced that the sequencing of reforms should follow this pattern.

I will not try to evaluate the statistical method applied nor going through the myriad of details. While the data are impressive, it would help if the authors could try to consolidate their results.

The AAG paper sets a landmark in extracting information from their model on an issue of highest importance for the functioning of EMU. Overall, their results are consistent with those of other studies. In the meantime the European Commission has published its “EMU@10 Report”. In its Quarterly Report, Vol. 7 (2008), Special Report “EMU@10” the summary concludes:

“The evidence is not very conclusive, but it is clear that on balance the single currency has had little positive effect on the pace of structural reform⁴ ... Consistent with these findings, the analysis ... indicates

⁴ Duval, R. and J. Elmeskov (2006), “The effects of EMU on structural reforms in labour and product markets”, ECB Working Paper Series, No. 596, March, see no acceleration of reforms in EMU. A slowdown in reforms in 1999-2004 relative to 1994-1998 is reported by Duval R. (2005). “Fiscal positions, fiscal adjustment and structural reforms in labour and product markets”, in S. Deroose, E. Flores, and A. Turrini (eds.) (2005), “Budgetary implications of structural reforms”, European Economy – Economic Papers, No. 248.

that euro-area countries have on average been less forthcoming in implementing the structural policy recommendations made to them by the EU under the Broad Economic Policy Guidelines (BEPGs) – a Treaty-based tool for economic policy coordination – in the period 2000-2005. In particular, progress in the cross border integration of services has been more muted than expected, which is particularly problematic. It is in this area especially that price rigidities persist. This has been recognised by the European Commission, which in turn has led to intensified surveillance of national structural policies in the euro area in the framework of the Lisbon Strategy for Growth and Jobs, which was revamped in 2005”.

A paper by Pelkmans and co-authors shows that product market reforms do help to “lubricate” adjustment processes in the euro area.⁵

Where is EMU going?

Notwithstanding remaining lack of flexibility especially in labour markets the single monetary policy has worked with great success, certainly better than even the optimists had expected. This result might trigger a new discussion on the relevance of the OCA criteria. Financial integration might have played a role. Consumption

⁵ J. Pelkmans, L. Acedo Montoya, and A. Maravalle (2008), How product market reforms lubricate shock adjustment in the euro area, *European Economy, Economic Papers*, 341.

smoothing and risk sharing should have contributed to the functioning of EMU.

On the other hand significant challenges are ahead. Countries which continuously have lost competitiveness inside the euro area are confronted with heavy adjustment problems and the slowdown of growth will reveal the lack in ambition on structural reforms throughout the euro area. The costs of the current financial crisis for the real economy will to a large extent depend on the flexibility of labour and product markets, in particular on (downward) flexibility of labour costs and prices. The title of the last chapter in my book, “Europe at the crossroads”, is a kind of short cut message. TINA – there is not alternative to structural reforms – remains true if the coherence of the area is to be preserved and the functioning of the single monetary policy guaranteed. The alternative is anything but promising: increasing tensions – economically and political with far reaching consequences.