Enlargement of the Euro Area

On Monetary and Political Union

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Recent political developments in Europe, in particular the rejection of the European Constitution in France and the Netherlands in 2005, are leading to soul searching about the future of the European Union. There can be little doubt that these developments signal distrust of further political integration in Europe. There can be little doubt that this distrust has been intensified as a result of the enlargement process.

The risk that the process towards political union will be halted or even reversed has triggered a new debate about the link between political and monetary union. Two schools of thought have emerged. According to one school, monetary union cannot survive in the long run without a strong political union among the member states. This school of thought seems to have history on its side. Monetary unions that were not embedded in a strong political union have not survived.

According to the second school of thought, the present degree of political unification reached in the EU is sufficient to guarantee the long-run survival of the monetary union. In this view, the eurozone can survive even if the EU does not become a federal state like the United States of America.

The debate between these two views about the link between political and monetary union is made difficult by a lack of clarity about the meaning of political union. While a monetary union can easily be defined, i.e. it is a union between countries that use the same currency which is managed by one common central bank, such a neat definition is not easily found for the concept of political union. There are many dimensions and many gradations of political union. In contrast to monetary union, a political union is not a black or white affair that allows us to say when exactly the political union has been reached.

In this article we analyze the link between political and monetary union. We start by clarifying the concept of political union, and we then go on analyzing what kind of political union is necessary to sustain the monetary union in the long run.

The many dimensions of a political union

A political union has many dimensions.[1] Let us distinguish between an institutional and a functional dimension.

At the institutional level one can analyze the nature of the institutions that govern the union. There can be little doubt that the European Union has now developed a whole set of institutions to which the member states have delegated part of their national sovereignty. There is an executive branch consisting of the Commission and the Council. There is a legislative branch consisting of the Council and the European Parliament, and there is a judicial branch, the Court of Justice. Apart from the peculiar role of the Council as an institution with both a legislative and executive responsibility, the European Union has all the institutions of a modern democracy, capable of taking decisions that have a direct impact at the national level. In this sense there is already a significant degree of political union within the EU. The question we will have to analyze is whether the existing level of political union is sufficient to sustain the monetary union.

What is the link between political and monetary union?

At the functional level one can ask the question about the areas in which the member states have

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I am grateful to Helge Berger, Elisabetta Croci Angelini, Francesco Farina, Marc Flandreau, Franco Praussello, Francesco Saraceno, Waltraud Schelkle, An Sibert, Cezary Wójcik, Patrizio Tirelli and Frédéric Zumer for comments and criticism on previous versions of this article.

[1] It is not the intention here to develop a full-fledged theory of political unions. We only want to highlight those features that are important for the debate about the link between political and monetary union. For a profound analysis, see the well-known textbook of Wallace and Wallace(2000).

transferred their sovereignty to the European institutions. Here we have a very diverse picture. In some areas, the transfer has been significant. In agriculture, competition policy, external trade policy there is a substantial transfer of sovereignty.

In other areas there has been very little transfer. The most prominent (economic and social) areas where the member states have maintained the whole or close to the whole of their sovereignty is taxation, social security, wage policies, to name the most obvious ones. There are other areas where the transfer of sovereignty has been very limited, e.g. defense and foreign policies.[2]

Thus it appears that the transfer of sovereignty has proceeded in a very unequal way in the European Union, some areas being characterized by almost complete transfer of sovereignty and others by only very limited transfers.

The question that arises is what areas are important for a monetary union. Do we need a transfer of sovereignty in all these areas so that the European institutions become the embodiment of a true "superstate", or can this transfer be selective? If the latter is true, what principles should be followed to allocate responsibilities between the union and the member-states? In order to answer these questions we turn to the theory of optimal currency areas.

Some macro-economic policy instruments have been transferred to EU institutions, but whithout political accountability

The theory of optimal currency areas and political union

There is a fundamental difference between the monetary union between the US states and the European monetary union. The US federal government has a monopoly of the use of coercive power within the union, and will surely prevent any state from seceding from the monetary union. The contrast with the member states of the eurozone is a very strong one. There is no supranational institution in the EU that can prevent a member state of the eurozone from seceding. Thus, for the eurozone to survive the member states must continue to perceive their membership of the zone to be in their national interest. If that is no longer the case, the temptation to secede will exist and at some point this temptation will lead to secession.

The theory of optimal currency areas determines the conditions that countries should satisfy to make a monetary union attractive, i.e. to ensure that the benefits of the monetary union exceed its costs. This theory has been used most often to analyze whether countries should join a monetary union. It can also be used to study the conditions in which existing members of a monetary union will want to leave the union.

In its most general formulation the OCA-theory says that if the benefits of the monetary union exceed the costs, member countries have no incentive to leave the union. They form an optimal currency area. Or put differently, they are in a Nash equilibrium, and the monetary union is sustainable.

The conditions that are needed to guarantee sustainability are well-known from the literature on optimal currency areas (OCA).[3] They can be summarized by three concepts:

- Symmetry (of shocks)
- Flexibility
- Integration

Countries in a monetary union should experience macroeconomic shocks that are sufficiently symmetric with those experienced in the rest of the union *(symmetry)*. These countries should have sufficient *flexibility* in the labor markets to be able to adjust to asymmetric shocks once they are in the union. Finally they should have a sufficient degree of trade *integration* with the members of the union so as to generate benefits of using the same currency.

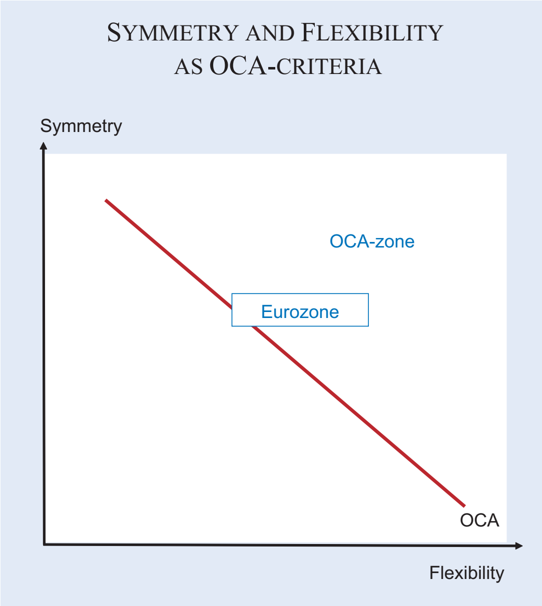
One can summarize this theory in the form of graphical representations. This is done in figures 1 and 2.

Figure 1 presents the minimal combinations of *symmetry* and *flexibility* that are needed to form an optimal currency area by the downward sloping OCA-line. Points on the OCA-line define combinations of symmetry and flexibility for which the costs and the benefits of a monetary union just balance. It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility. To the right of the OCA-line the degree of flexibility is sufficiently large given the degree of symmetry to ensure that the benefits of

[2] For a more detailed analysis see Alesina, et al. (2001) and Alesina and Spolaore (2003).

[3] McKinnon (1963), Kenen (1969).

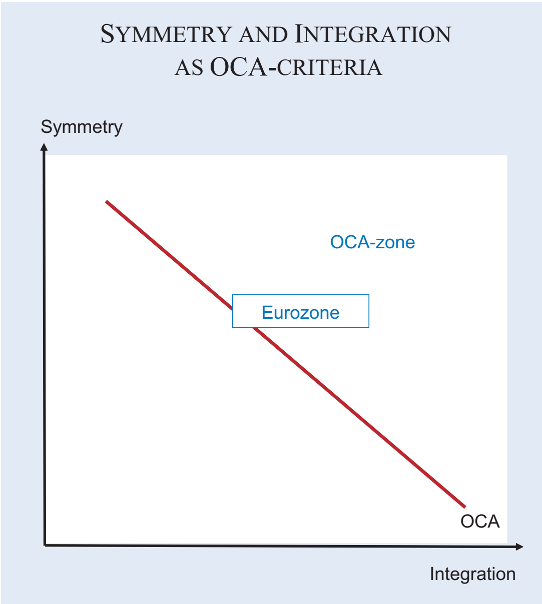
Figure 1



the union exceed the costs. To the left of the OCA-line there is insufficient flexibility for any given level of symmetry.

Figure 2 presents the minimal combinations of *symmetry* and *integration* that are needed to form an optimal currency area. The OCA-line represents the combinations of symmetry and integration among groups of countries for which the cost and benefits of a monetary union just balance. It is downward sloping for the following reason. A decline in symmetry raises the costs of a monetary union. These costs are mainly macroeconomic in nature. Integration is a source of benefits of a monetary union, i.e. the greater the degree of integration the more the member countries benefit from the efficiency gains of a monetary union. Thus, the additional (macroeconomic) costs produced by less symmetry can be compensated by the additional (microeconomic) benefits produced by more integration. Points to the right of the OCA-line represent groupings of countries for which the benefits of a monetary union exceed its costs.

Figure 2



We have put the present eurozone (EU-12) within the OCA-zone, but close to the border line, taking the view that the eurozone may be an optimal currency area, however, without being really sure of this. The eurozone may also be on the left had side of the OCA-line. This implies that we are not really sure whether it is sustainable in the long run. As a result, there may be scope for improving the sustainability of the eurozone.

How does political integration affect the optimality of a monetary union?

The degree of political integration affects the optimality of a monetary union

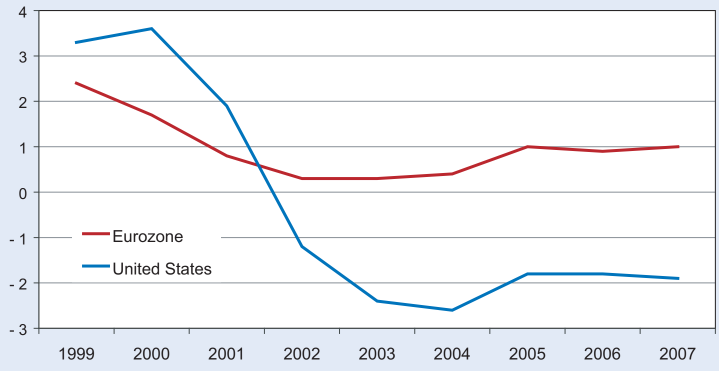
We take the view that the degree of political integration affects the optimality of a monetary union in several ways. First, political union makes it possible to centralize a significant part of national budgets at the level of the union. This makes it possible to organize systems of automatic fiscal transfers that provide some insurance against asymmetric shocks. Thus when one member country is hit by a negative economic shock, the centralized union budget will automatically transfer income from the member states that experience good economic conditions to the member state experiencing a negative shock. As a result, this member state will perceive the adherence to the union to be less costly than in the absence of the fiscal transfer.

Second, a political union reduces the risk of asymmetric shocks that have a political origin. To give some examples that are relevant for the eurozone. Today spending and taxation in the eurozone remain in the hands of national governments and parliaments. As a result, unilateral decisions to lower (or to increase) taxes create an asymmetric shock. Similarly, social security and wage policies are decided at the national level. Again this creates the scope for asymmetric shocks in the eurozone, like in the case of France when that country decided alone to lower the working week to 35 hours. Or take the case of Germany which, by applying tough wage moderation since 1999, dramatically improved its competitive position within the eurozone at the expense of other countries, e.g. Italy (see next section where we elaborate on this). From the preceding it follows that political unification reduces the scope for such asymmetric shocks.

Figure 4

CYCLICALLY ADJUSTED BUDGET BALANCE IN THE EUROZONE AND THE US

Cyclically adjusted balance, general government



Source: European Commission.

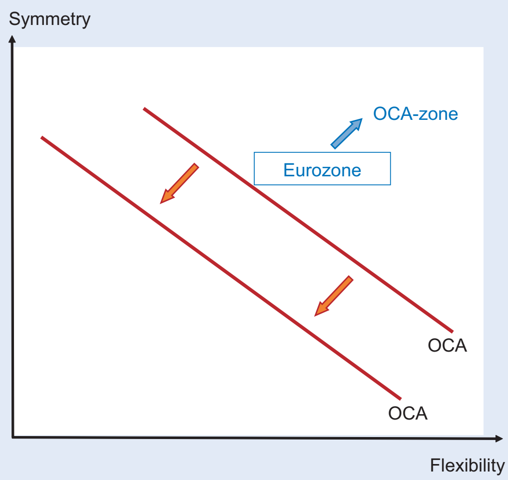
The way one can represent the effect of political unification is twofold (see Figure 3). First, the existence of a centralized budget makes it possible to alleviate the plight of countries hit be a negative shock. Thus the cost of the union declines for any given level of asymmetry. This has the effect of shifting the OCA-lines downward in figures 1 and 2.[4] Second, political union reduces the degree of asymmetry, thereby shifting the eurozone upwards. As a result of these two shifts, political unification increases the long-term sustainability of monetary unions.[5]

A centralized budget as a redistributive device reduces the cost of the monetary union

From this brief survey of the OCA-theory we conclude that in order to enhance the sustainability of a monetary union it is important to have a central budget that can be used as a redistributive device between the member states and it also matters to have some form of coordination of those areas of national economic policies that can generate macroeconomic shocks.

Figure 3

POLITICAL INTEGRATION AND THE OPTIMALITY OF THE EUROZONE



A central budget is important as a redistributive device. It also matters as a stabilizing instrument.[6] The absence of a central budget in the eurozone implies that no budgetary policy aimed at stabilizing the business cycle in the union is available. The question that arises here is how important this is. In Figure 4 we show the contrast between the US and the eurozone since 1999. We observe that the US allowed its budget deficit to increase significantly as a response to the recession of 2001. There is no central budget in the eurozone but the aggregate of the national budget balances could work in a similar stabilizing way. The evidence of Figure 4, however, shows that this aggregate did not respond to the worsening economic conditions in the eurozone from 2002 on. Thus there is an absence of a system-wide budgetary policy in the eurozone capable of performing a stabilizing role at the level of the eurozone.

Asymmetric shocks and lack of political union

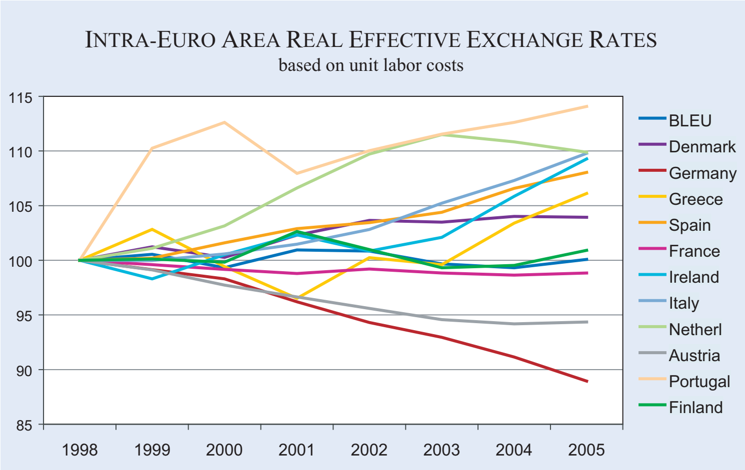
One of the surprises of the functioning of the eurozone has been the extent to which the competitive positions of the eurozone countries have diverged. We show the real effective exchange rates in the

[4] It is important that these transfers be reversible to maintain their insurance character. If these transfers attain a permanent one way character they are likely to become unpopular in the “donator”-country, leading to a perception of a high cost of the monetary union. This calls for the use of transfers only to alleviate the effects of temporary asymmetric shocks (business cycle movements) or in the case of permanent asymmetric shocks to make these transfers temporary allowing receiving countries to spread the adjustment cost over a longer time.

[5] A similar analysis can be done using the symmetry-integration space of figure 2.

[6] Musgrave (1959) introduced the different functions of a government budget, as a distributive, a stabilizing and an allocative function.

Figure 5



Source: European Commission.

This German policy of wage moderation has not been without consequences for the other eurozone countries which have seen their competitive positions deteriorate thanks to these German wage policies. Thus the latter have worked as "beggar-thy-neighbor" policies forcing other countries in turn to also institute drastic policies of wage moderation.[8] In this sense the lack of political union is responsible for a coordination failure and the emergence of a major asymmetric shock that will have to be corrected.

Coordination of national policies would prevent the emergence of asymmetric shocks

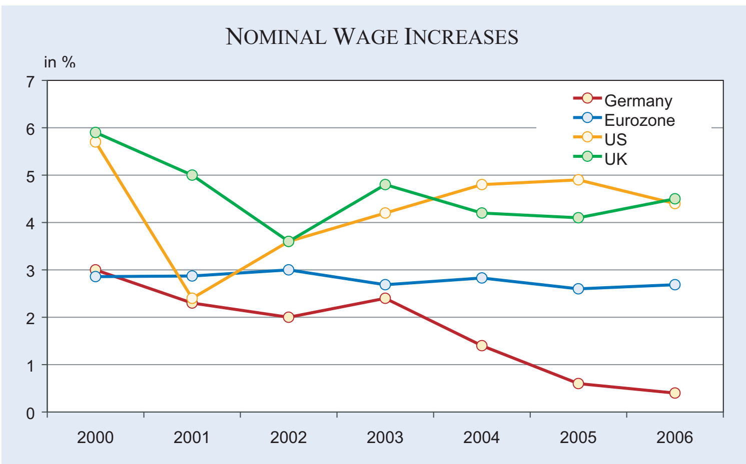
eurozone (based on unit labor costs) since 1998 in Figure 5. The striking fact is the extent to which the relative unit labor costs have tended to diverge. As a result of these trends, some countries (Portugal, Netherlands, Spain and Italy) have lost a significant amount of price and wage competitiveness. Others, like Germany and Austria have gained a significant amount of price and wage competitiveness.[7]

There can be no doubt that part of these divergent developments in prices and wages are the result of divergent national wage policies. Since 1999, Germany has followed a tight policy of wage moderation. We show some evidence in Figure 6. This presents the yearly nominal wage increases in Germany and in the rest of the eurozone (excluding Germany). We observe the strong decline of nominal wage increases in Germany. The rest of the eurozone maintained more or less constant wage increases around 3 percent per year. Thus, each year Germany tended to improve its competitive position vis-à-vis the rest of the eurozone. The contrast between Germany on the one hand, and the UK and the US on the other, is even stronger. The latter allowed their wages to increase by 4 or 5 percent per year.

The correction mechanism is likely to be painful. Other countries will be forced to intensify their policies of wage moderation, inducing the former again to restrict wage increases.

The divergent movements of competitive positions within the eurozone are not only the result of German wage policies but also of the different speeds in the structural reform process in the member countries. The process of structural reforms (labor market reforms, liberalization of output markets) has remained a strictly national affair. Some countries, e.g. the Netherlands and Spain have gone some way in deregulating employment protection systems, while other countries, e.g. France and Italy have a

Figure 6



Source: European Commission, Statistical Annex to the European Economy.

[7] It could be argued that these trends may also be the result of different initial levels of per capita income so that they reflect a catch-up process (Balassa-Samuleson effect). Since the real effective exchange rates shown here are based on unit labour costs they take into account differences in productivity growth.

[8] For a similar analysis in the context of the EMS, see Blanchard and Fitoussi(1992).

long way to go. These divergent movements have much to do with differences in national political systems. They generate a potential for divergent movements in employment and output (asymmetric shocks) within the eurozone which will necessitate adjustments in the future. As these are likely to be painful, they are bound to lead to tensions in a monetary union.

The enlargement of the eurozone to the new member states will not make matters easier. Each of the new member states, like the old member states, has its own national idiosyncrasies. Thus an enlarged eurozone will present even more scope for divergent economic developments, creating difficult adjustment processes and tensions within the system.

The institutional weakness of the present eurozone governance

The present institutional design of the eurozone is weak. This weakness manifests itself both at the level of fiscal policies as at the level of monetary policies.

Without further political integration, EMU is at risk

The Stability and Growth Pact (SGP) was supposed to provide the cornerstone of the governance of fiscal policies in the eurozone. The SGP, however, is built on a weak institutional foundation. The reason is the following. As argued earlier, spending and taxation are still very much the responsibility of national governments and parliaments. That is also the level at which democratic legitimacy is vested. As a result, these spending and taxation decisions are backed by an elaborate process that is deeply embedded in national democratic institutions.

The SGP now imposes top down an extensive control and sanctioning system on the net effect (budget deficit) of this democratic decision making process by institutions that are perceived to lack the same democratic legitimacy. Lawyers will undoubtedly object that the SGP is the result of a Treaty that has been ratified by the same democratic institutions, the national parliaments, so that it has the same legitimacy as the national parliaments. This is undoubtedly true from a legal point of view. It is not from a political point of view.

When the Commission starts an excessive deficit procedure which aims at forcing national governments to cut spending and/or increase taxes, it bears no political responsibility for these decisions. In fact, the national governments do. When these follow up on the Commission's procedure and cut spending and raise taxes they are the ones who will be judged by their national electorates, and who face the threat of being punished by the voters at home. In contrast, the European Commission at no time faces the prospect of being voted out. Thus from a political point of view, the European Commission, which initiates the control and sanctioning procedure of the SGP, lacks democratic legitimacy, because there is no mechanism to make the Commission accountable for its actions to an electorate.

This lack of accountability of the Commission makes the SGP unsustainable. Each time a conflict arises between the Commission and the national governments, the former is bound to loose. This is also what has happened in November 2003 when France and Germany disregarded the SGP. It will happen again when conflicts arise between the Commission and the national governments. Thus, it can be concluded that the SGP is a fragile institutional construction that is unlikely to meet its objective.

On the need for further political integration

In the preceding sections we have argued that there is a deep problem of governance in the Eurosystem. We identified three problems. First, important instruments of macroeconomic policy (monetary policy and the management of the government debt and deficits) have been transferred to European institutions. However, the political accountability for the results of the decisions taken in these fields is still vested with national governments. This creates a tension that is bound to be won by national governments.

Second, the eurozone lacks a system of redistribution that will compensate those who are hit by a negative shock. These negative shocks, quite surprisingly, have remained large within the eurozone. One cannot simply tell those countries faced by such a shock that they should solve the problem on their own. A redistributive system is essential to create an "allegiance" to the union, which in turn is important to maintain its sustainability.

Finally, the fact that large areas of economic policies remain in the hand of national governments create asymmetric shocks that undermine the sustainability of the monetary union.

These three problems call for further steps towards political union. Without a political union the eurozone is at risk. The previous analysis allows us to describe how such a political union should look.

A first element of such a political union is a certain degree of budgetary union, giving some discretionary power to spend and to tax to a European executive, backed by a full democratic accountability of those who are given the authority to spend and to tax. This will allow setting up an insurance system against asymmetric shocks in the eurozone. This can take many forms, and several proposals have already been made (see e.g. Mélitz and Vori (1993), Von Hagen and Hammond (1995)). The transfer of budgetary power does not have to be spectacular as was shown by the previous authors. Nevertheless, it will require a European budget that increases significantly relative to its present level of about 1 percent of GDP.

Second, an increased institutionalized coordination of a number of economic policy instruments that have macroeconomic consequences will be necessary. We have mentioned social policies (including structural reform policies) and wage formation. The need to coordinate does not imply that these areas should be fully centralized. Rather it means that spillover effects of decisions in these areas into the monetary union should be internalized. Thus, decisions like cutting the working week in France which have obvious implications for the eurozone as a whole should be a matter of common concern, and should not be allowed to be decided by individual countries without consultation with other countries. Similarly, national wage policies will have to be coordinated in order to avoid asymmetric developments in competitive positions of the member countries.

An omitted "deep" variable

The German monetary union between West and East Germany that came about in 1990 after a transition period of barely six months stands in great contrast with the European monetary union. The German monetary union was part of a larger political union. Thus, on July 1, 1990 the monetary union was established together with a unification of all important macroeconomic instruments (budgetary policies, transfer system, wage bargaining, social security, regulatory environment). There can be no doubt that such a comprehensive political union came about as a result of a strong national sense of common purpose and an intense feeling of belonging to the same nation.[9] In a way it can be said that this sense of common purpose was the deep variable that made the monetary and political union possible in Germany. Put differently, monetary and political union were endogenous variables that were driven by a common force. The existence of this deep variable made it inconceivable that Germany would have started with a monetary union without having a centralized budget capable of making large transfers between regions, or without a unified social security system.

This deep variable is absent at the European level. It is this absence that makes the progress towards political union so difficult in Europe. The lack of a deep variable also explains why Europe started with monetary union. The latter can be considered to be the easy part on the road to political union. But at the same time it puts the whole process at risk. Without a sense of common purpose it is very doubtful that further progress towards political union will be made. And as we have argued, without these steps towards political union the monetary union will remain a fragile construction.

Without a deep sense of common purpose, progress towards political union will remain evasive

From this perspective, the enlargement of the eurozone, which starts on January 1, 2007 with the entry of Slovenia, is not good news. There can be little doubt that the enlargement will weaken the sense of common purpose. The deep variable that drives the dynamics towards political union will become even weaker than it already is. Thus the enlargement of the eurozone will set back the dynamics towards political union even further, thereby increasing the fragility of the eurozone.

Conclusion

The long-run success of the eurozone depends on the continuing process of political unification. Such a political unification is needed to reduce the scope for the emergence of asymmetric shocks and to embed the eurozone in a wider system of strong political ties that are needed to take care of the inevitable divergent economic movements within the euro-

[9] See Baldwin and Wyplosz (2006) on this issue.

zone. In addition, such a political union is necessary to deal with the flaws in the governance of the eurozone. The major flaw is that while national politicians continue to bear the full political responsibility for unfavorable trends, key instruments to deal with this problem have been taken away from them and have been transferred to European institutions that bear no political responsibility for their decisions.

The recent "no" votes concerning the European constitution signal that there is a strong "integration fatigue" in the European Union today, making it unlikely that significant progress in political unification can be made. The recent enlargement of the European Union will make it even more difficult to move towards political union. It may even lead to a loosening of the political ties within the EU.

The absence of a political union will continue to make the eurozone a fragile regime. In the long run, however, there can be little doubt: without further steps towards political union the eurozone has little chance of survival.

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