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The Eurozone under Serious Pressure

Regional Economic Cycles in the Monetary Union Need to Be Stabilised

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In debates about the future of the EU, the eurozone is regularly held up as a stable core element that could potentially deepen cooperation across broad policy areas. Undoubtedly the 12 EMU Member States have a keen interest in maintaining and consolidating the European Monetary Union as a framework for stability and growth. This makes it all the more alarming that regional economic cycles are putting serious pressure on the eurozone, generating major potential for political conflict. In June the Council of Ministers will ponder on the European Union's response to this problem. A European transfer mechanism to stabilise regional economic cycles could avert the danger of the Monetary Union breaking up. A European corporate tax scheme or a form of European unemployment insurance system, each of which would complement their respective national counterparts, would have the desired effect without increasing contributions. This would give Europe the kind of social component it is currently missing—a fact criticised in the debate about the European Constitution.

The latest economic data show clearly that in macroeconomic terms, the eurozone is functioning markedly worse than had been expected prior to the introduction of the single currency. Since the economic recovery began in 2003, regional economic cycles have been drifting apart. In fact the eurozone is splitting up into blocs, one comprising countries like Spain and France (which are growing rapidly but experiencing relatively high inflation), and another comprising countries like Germany and the Netherlands, which are experiencing very little growth and low inflation. Whilst the aforementioned economic cycles are drifting apart, the base lending rate of the European Central Bank (ECB) is no longer appropriate for all countries. Instead, it is exacerbating the economic problems of some eurozone states.

Stagnation Coupled with Low Inflation

In Germany's view the ECB's interest rate is too high and constitutes an additional obstacle to growth. Indeed, a downward spiral has set in, with weak demand and very muted income dynamics leading to virtually no underlying inflation. (Only increases in indirect taxes and administered prices are keeping inflation above

1 percent.) As a result, for those companies making sales primarily in the German market, financing costs (which are influenced by the ECB base rate) are relatively high. This trend is undermining investment, triggering more redundancies and further weakening the economy. Meanwhile, continuing low demand is exerting additional pressure on prices and wages.

This line of argument still holds true in spite of the currently (by historical standards) low nominal short-term interest rates: Over the last few years the world economy has suffered some severe blows (such as the stock market crash, the terror attacks on 11 September 2001, the war in Iraq and soaring oil prices). These events have prompted central banks around the world to lower their interest rates aggressively. For some time interest rates in the USA, for instance, were significantly lower than the ECB's rate. So bearing in mind the unusual global situation, the ECB base rate should not be regarded as particularly low. Furthermore, econometric estimates based on past experience indicate that given the current rate of inflation and economic development in Germany, the Bundesbank (the German central bank) would have lowered interest rates much further. Consequently, the real interest rate for Germany should still be considered high.

But whilst companies targeting the domestic market are suffering under such circumstances, export-oriented companies are benefiting from the situation, for their wage costs are rising more slowly than those of their foreign rivals, making them gradually more competitive. Moreover, as they are providing for markets where prices are rising, their financing costs are less of a burden. Thus, Germany is expanding its market share abroad, especially in the rest of the eurozone.

Some of the negative effects outlined above are thus being compensated, albeit only to the extent of the relevant country's economic integration into the remainder of the eurozone. Although Germany is highly dependent on exports to the EMU, this dependency is nowhere near as great as that of smaller countries (like the Netherlands or Belgium). A large proportion of SMEs in particular are continuing to produce goods and services exclusively for the German market. As a result, the impulse from external demand is insufficient to kick-start the labouring domestic economy.

Growth and Pressure on Prices

The situation in Germany is very different to that in countries like Spain or France, where pay increases and inflation are clearly higher than in the Federal Republic. Corporate financing costs, which are influenced by the European Central Bank, are highly favourable compared to the conditions under which sales are effected in companies' domestic market. As a result, investment and domestic demand are stronger, which in turn keeps inflation and pay increases relatively high.

This mechanism is receiving an additional boost from an ongoing property boom. Sizeable pay increases and higher inflation are giving people a larger disposable income. Moreover, the low nominal cost of borrowing makes buying a house or flat seem more appealing. This in turn is fuelling demand for property and the construction of new housing and pushing up prices. Private households are feeling increasingly wealthy because of the higher value of their property. Consequently, they are able to take out higher mortgages, and are more willing to spend. In recent years this mechanism has been the key to robust consumption growth in France, Spain and Ireland, whereas exports contributed little towards economic growth in these countries.

Textbook Models Prove Inaccurate

Economic theory holds that, in time, these differences in the Monetary Union should reverse: If price increases make a country like Spain become less competitive (and

therefore lose some of its share of the global market), economists would expect a regional economic decline to set in. This in turn would result in lower inflation and smaller wage increases than elsewhere in the eurozone, prompting more burdensome financing costs, paralysing consumption and investment, and boosting unemployment.

By contrast, competitiveness in countries facing economic problems (like Germany or The Netherlands) should eventually improve sufficiently for export growth to turn around the labour market, raise the wage bill and kick-start consumption. Nominal wages and inflation should then rise again. In such a situation the previously stagnating country would benefit from a relatively favourable cost of borrowing and the national economy would enjoy above-average growth.

This is what the economic textbooks on which the construction of the European Monetary Union was based claim should happen. However, those theories fail to take account of all the damaging consequences of the very low (or in an extreme case negative) rate of inflation and weak domestic demand. As the experience over past years has shown, however, this view is overly optimistic.

Any economic downturn leads to bankruptcies associated with loan defaults, which in turn undermines banks' equity position. If a downturn persists for an unusually long time (as is currently the case with Germany's domestic economy), the associated balance sheet adjustments place a very heavy burden on the affected banks. This, in turn, can hamper—or in the worst-case scenario even block—economic recovery, for once the banks' equity position has been weakened, they will set about continuing to consolidate their balance sheets again before awarding fresh loans. In an extreme scenario a national banking crisis could occur, if the amount of non-performing loans grows big enough to cause solvency problems in one or more of the major banks in a specific country. Complaints by many German SMEs about restrictive lending practices and the problems faced by German banks which have lost substantial amounts of their capital show that over the past few years the continuing economic downturn in Germany aggravated the difficulties faced by the banking sector, and vice versa.

Cycles Are Slow to Change

Economists have been surprised by the sheer duration of regional boom-and-bust cycles in the eurozone. Within the European Monetary Union, improving competitiveness (compared with the constrictive effects of high regional real interest rates) is having significantly less impact on economic growth than anticipated.

Empirical research suggests that in the USA it can take around nine years for half of the inflation differential between two American cities to even out. In that process, a higher rate of inflation can stimulate a region in the short term, and the consequences of weaker competitiveness only start to become apparent after three or four years.

In the eurozone it will probably take even longer to reverse competitive imbalances between regions, because the markets for goods—and above all services—in Europe are not very well integrated. Banks still prefer awarding loans to their national or even sub-national constituency. None of this was anticipated when the Monetary Union was designed in the early 1990s.

One reason for this is that the political objective of establishing a liberalised internal market for goods, services and people (including the working population) as set out in the EU treaty on which that policy was based at the time—the Single European Act—was supposed to be attained by the end of 1992. However, unlike the situation in the USA, today the European Monetary Union still has no harmonised capital market: Most companies rely on their principal banks, with which they

usually have a year-long business relationship. These banks in turn are badly hit by regional downturns as their credit portfolios are heavily concentrated on the regional economy. Consequently, they may tend to ease their lending criteria during regional booms and tighten them during downturns, thereby exacerbating and prolonging regional upswings and downturns.

The European Commission and the European Central Bank are also becoming increasingly aware of the problem caused by regional economic cycles drifting apart. In the ECB's Monthly Bulletin for May 2005, the bank concludes that the differences between national rates of inflation within the eurozone are significantly more persistent than in the USA.

Eliminate Structural Weaknesses of the Monetary Union

The fact that individual countries, like Germany, find themselves faced with the problems described above as a result of the ECB's interest rate conditions does not mean that they would gain from leaving the eurozone—on the contrary. Back in pre-EMU days, the latest decrease in the value of the dollar would have led to highly fluctuating exchange rate within Europe, impacting substantially on Germany's exports, which account for 40% of the country's GDP.

For the southern European countries, which are currently enjoying extremely expansionary monetary conditions thanks to a booming housing market and higher inflation, a break-up of the eurozone could reverse monetary convergence and raise long-term inflation expectations. Long-term interest rates would probably rise steeply and the catching up done by their economies in real terms could come to a standstill. In addition, each Member State would find the cost of restoring a national currency very high. So it cannot be in the interests of any country to leave the eurozone or dissolve it altogether.

Instead of speculating about pull-out scenarios, it makes far better sense to analyse the structural flaws built into the European Monetary Union. Discussing the processes and institutions required by the Monetary Union to work more efficiently is not an admission of failure. It is rather a sensible 'post-hoc' adjustment of a historically unique step down the road to integration. The decision on paper to go ahead with the European Monetary Union was taken around 15 years ago. Not all the predictions made back then have turned out to be accurate. Six years after the actual launch of the EMU, it is both legitimate and necessary to draw on what we now know to make it a complete success.

Press Ahead with Economic Integration

One way of preventing economies from drifting apart too much would be to press ahead with economic integration in Europe. If competition between national players and their rivals from the rest of the eurozone could be enhanced in the markets for goods and services, changes in regional competitiveness would impact sooner on (national) economic growth. For this reason, measures such as legislative alignment and the mutual recognition of licenses and approvals (as planned in the Services Directive) would probably make the European Monetary Union function better. Consequently, measures like the Lisbon objectives entailing the transposition of all directives to do with the internal market and the imposition of common education, research and development programmes, and ongoing programmes designed to promote cross-border cooperation between companies in the EU are steps in the right direction.

Another important goal is to create genuine cross-border capital markets. First and foremost, the banks—which have in the past often tended to be just regionally or nationally active—must be induced to diversify their credit portfolios more and

become pan-Eurozone players. Mergers could help in this respect, reducing the effect of banks' regional orientation which amplifies regional economic cycles. The European Commission Green Paper published in April 2005 and the White Paper planned for the end of the year are further important milestones along this road. The Green Paper discusses the most pressing problems and needs for action, especially in the private consumer sector, which still lacks transparency and reliable rules. Any recommendations made by the Commission that foster the integration of financial markets should be transposed by the Member States.

Transfer Mechanism Required

However, other federal systems' experience with a single currency (especially the USA, but also Canada, Brazil or the Federal Republic of Germany) show that even a very high level of integration is not sufficient to rein in the problem of regional boom-and-bust cycles altogether. The United States has embarked on a successful path, endorsed by economic theory, by stabilising its regional economic cycles both through national income tax and public sector spending and via unemployment insurance contributions and payouts.

When one state in the USA is booming, it contributes more tax revenue to the central budget. When a regional economy is in difficulty, unemployment benefits are paid. Empirical research suggests that in this way around 15 to 20% of regional economic downturns are offset. The success of monetary union in the USA, on the one hand, and the described problems of the eurozone, on the other, suggest that a similar stabilisation mechanism could make sense for the eurozone.

By definition, the EU's regional and structural policy do not guarantee such compensation because the distribution of resources and contributions to the Union's budget are fixed years in advance and pursue other goals. They do not respond to economic fluctuations.

Using national finance policy to offset the problem of demand is no solution either. For although the reformed Stability and Growth Pact offers countries with precarious economies (like Germany) a wider range of options for using intervening financial policy instruments, now that a swift budget consolidation is more closely dependent on the economic situation, the countries in question have greater leeway to combat the downward spiral by lowering taxes or increasing public spending at times when inflation is low.

Nonetheless, there are growing doubts as to whether the Member States of the Monetary Union are genuinely capable of preventing a national downturn in a 'bust phase' merely by wielding national fiscal policy instruments. Many countries' national debt and deficits are so huge and their current rate of growth is so muted that it is questionable whether fiscal measures adopted by one country on its own can still generate sufficient economic momentum. In 2004 Germany's general government deficit was clearly above 3% of GDP—without any additional measures to support the economy. If we currently assume that prices will hardly rise over the coming years (going up roughly 0.5% per annum) and postulate a trend towards real growth of 1.5%, a deficit of a mere 3% of GDP would mean the stock of debt stabilising only at 150% of GDP, a value that is clearly not sustainable. Any expansion of the national deficit would lead the country in question to stray further off the path to sustainability. The latest experience gained in the USA show that a Keynesian demand-oriented policy does effectively get the economy moving. Yet above a certain deficit or level of indebtedness the possibility cannot be ruled out that a further increase in the budget deficit will dent consumer and corporate confidence to such an extent that only minor economic momentum will remain.

For this reason it would be a good thing to organise measures designed to stabilise regional economic cycles at European level. The measures in question could conceivably not only be highly beneficial for Europe in economic terms, but also have the added advantage of appeasing any critics of the European Constitutional Treaty, who for instance called for a 'more social Europe' in the French referendum debate.

Two main ideas predominate here: firstly, a European corporate tax, and secondly a European unemployment insurance. Both possibilities should be discussed by the Euro Group and within the EU-25. The Euro Group meeting on 6 June, at which the European Commission is due to submit a report on the tensions in the eurozone, constitutes the first major opportunity to hold such a discussion.

Arguments in Favour of a European Corporate Tax

In the case of a European corporate tax, the EU could collect tax at a rate of around 10% on all profits made in the Union. This tax revenue could be used to finance the EU budget. As a result, individual Member States would no longer have to pay contributions to the EU institutions out of national budgets. The exact rate of taxation should be fixed in such a way that the revenue generated by the tax corresponds roughly to the present-day EU budget. Each country would have the further possibility—just like individual states in the USA—of levying additional tax on companies' profits. Some countries would desist altogether from using such an option, whereas others might levy a supplement that would make their tax burden more or less comparable to their current commitment. Since the burden on national budgets would simultaneously be eased, there would be no reason to expect companies and citizens to be subjected to higher taxes overall.

In this way, a minimum corporate tax would be set within the European Union, but fiscal competition would not be prevented. Since an EU tax would require a common EU tax base, the situation would also be rendered more transparent for companies.

The most important consequence would be to establish regional automatic stabilisers via revenue, as corporate profits are usually particularly high during economic booms. During such a phase a country would contribute a particularly high amount to the EU budget. On the other hand, the respective national government's tax revenue would be less voluminous, which would probably prevent politicians from stepping up spending pro-cyclically or lowering taxes.

By contrast, profits are usually very low when the economy is troubled, so the payments sent to Brussels would diminish correspondingly. In such a situation national budgets would be subjected to a lesser burden than previously, and pro-cyclical spending cuts would be unlikely.

Arguments in Favour of a Form of European Unemployment Insurance

The second pillar of the stabilising mechanism would be a form of European unemployment insurance. The safety nets designed to protect unemployed people differ in the individual euro countries. However, most such countries levy social security contributions on wages which they then use to pay out unemployment benefit. Some of this insurance could be collected at European level.

The problem associated with the existence of different levels of benefit in the various countries is far less serious than it may appear at first glance. Of course, it would make little sense for, say, an unemployed Portuguese worker to receive the same unemployment benefit as a skilled worker in Germany, i.e. in this case a payout that was higher than the normal wage in Portugal. As with national unemployment insurance schemes, the level of benefit awarded should depend on the

previously earned income. Moreover, to prevent individual countries from shying away from unpopular reforms that would reduce their national employment figures and thereby from passing on the social costs to the European unemployment insurance, the maximum duration of the support provided out of the European system should be limited to a year.

As with the corporate tax discussed above, unemployment insurance at EU level would not impose the same standards on all countries. Instead, only a minimum level of security would be established, and each individual Member State could then make its own more generous arrangements via an additional national system.

The system could also be organised in the form of a safeguard for national unemployment insurance schemes, which would cede a certain proportion of their national wage bill to a European re-insurer. This re-insurer would then pump funds back into the relevant national insurance whenever an insured worker became jobless. Such a set-up would prevent national governments from having to raise their contributions in times of economic gloom or draw funds out of their state budget to feed into their unemployment insurance scheme. In economic boom times, national purchasing power would be skimmed off and paid out to those countries whose rate of growth was slower via the European insurance scheme.

Prospects of Realisation and Potential Scenarios

A European corporate tax and European unemployment insurance scheme would not just stabilise the European economy, but would also give the EU a 'more social' component, which would make the notion of European integration more palatable to the Union's citizens. At the same time, neither the scope of the European Commission's power to dispose of funds, nor the burdens on national budgets would increase. Consequently, despite their political reach, these proposals are not doomed to fail.

Both ideas could either be implemented for the EU-25 or for the 12 Member States of the European Monetary Union. For the European unemployment insurance it would be immaterial whether or not the countries signing up to it coincided exactly with the membership of the European Union, since it could function totally independently of the existing EU institutions. By contrast, introducing a European corporate tax scheme that applied only to countries with the euro would be more complicated, since it would require a special arrangement whereby they paid their contribution to the EU Budget out of the Monetary Union's corporate tax and, to make up for this, paid less into the Community budget out of their respective national budget.

For the twelve euro countries the economic arguments in favour of such a step towards further integration are far more compelling. Their political motivation will probably also be greater. After all, they are locked into the Monetary Union together and have learned a great deal from and alongside each other since 1999. Today in the Euro Group there is something akin to a culture of politico-economic debate, a common framework of analysis and a realistic awareness of mutual independency. Consequently, these proposals have better prospects of being realised within the eurozone today than comparable initiatives had in the past. For the basic idea is nothing entirely new: back in 1970 the Werner Plan—the first draft of a European Monetary Union—already contained the idea of a transfer system, as did the call in the 1990s by (then President of the *Bundesbank*) Hans Tietmeyer for a 'political union' to complement the Monetary Union.

After the failed referenda in France and the Netherlands, a joint initiative of this kind could initially fill the resulting political vacuum in a manner that was both politically convincing and made economic sense. However, quite apart from whether

or not the Constitutional Treaty is ratified, the consequences of failing to take action need to be thought through. Latest data suggest that even the steps towards liberalisation contained in the Lisbon agenda and the extension of the scope for national budgetary policy will not suffice to set problem countries like Germany or the Netherlands back on track towards growth.

One consequence would be the continued rise of unemployment in economically depressed countries. Yet in view of the intimate links between the Member States, other partners within the Monetary Union would also have to brace themselves for the negative impact on their growth and unemployment of failure by some (major) EU Member States to find their way back towards robust growth.

Looking back at the history of Europe tells us that societies in economically troubled situations tend to bend to the influence of populists, protectionists or even nationalists. Such nightmare scenarios may still seem a long way off, but there is nonetheless a danger that public sentiments stirred up by rising unemployment may turn them against further integration, or even against the headway made so far down the path towards that goal. Recently there have been modest indications of such stirrings, amongst other things in the debate about the liberalisation of the services sector (the Bolkestein Directive).

The implementation of the proposed transfer system would not entail any risks and would not have any negative effects if the problem of diverging regional economic cycles turns out to be less serious in the long run. If a European corporate tax was adopted, only the source of funds fed into the EU budget would change, not their amount or the financial burden on European citizens and companies. Within the European unemployment insurance scheme, there would be no transfer of funds whatsoever between the individual countries, if national economic cycles within the Monetary Union were in synch.

Furthermore, both proposals have no impact on the expenditure rate and public deficits of eurozone countries. Consequently, contrary to the fears expressed by some economists regarding the reform of the Stability Pact, there is no reason to anticipate the financial markets being jeopardised by any resulting changes—quite the opposite. This new step towards integration would not only bolster the sustainability of the European Monetary Union and thereby make the scenario of a break-up less likely. A transfer system aimed at cyclical stabilisation might even further push down risk premiums on euro securities, leading to lower long-term interest rates. This should in turn help consolidate growth in Europe.

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