The eurozone needs less heterogeneity.

André Sapir argues that all eurozone members need to have institutions that ensure wage developments are in line with productivity developments, and that this is crucial for the sustainability of the EZ.
Misalignments of real exchange rates continue to be the most visible and painful symptom of asymmetric shocks within the eurozone. An important factor behind such misalignment is the difference in national wage formation and bargaining systems, especially between core and periphery members. This column argues that all members need to have institutions that ensure wage developments are in line with productivity developments. This would eliminate an important source of asymmetric behaviour and reduce resistance to EZ-wide fiscal mechanisms capable of absorbing asymmetric shock.

Before the creation of the euro, the prevailing view in European economic circles was that economic and monetary union would reduce the incidence of asymmetric shocks. Policy-induced asymmetric shocks would be largely eliminated by the adoption of a single monetary policy and of fiscal rules that would impose sound national fiscal policies. Exogenous asymmetric shocks associated with structural differences between eurozone (EZ) countries were also considered less likely because EMU was supposed to produce structural convergence among these countries (see Buti and Sapir 1998).

Misalignments of real exchange rates may not be the ultimate source of asymmetric shocks, but they are typically their most visible and painful symptom. Whatever their fundamental cause, deviations of wage growth from labour productivity growth tend to create adjustment problems in a monetary union and should therefore be closely monitored and corrected before they become protracted and painful to adjust.

Unfortunately, the system of surveillance that operated in the EZ prior to the financial crisis was gravely deficient in this respect. In the days of the European Exchange Rate Mechanism, authorities monitored developments in real exchange rates (and competitiveness), and could use the nominal exchange rate to correct for losses in competitiveness. Prior to the crisis, however, national and European authorities seemed to have forgotten two elementary facts about a monetary union:
First, that the loss of the nominal exchange rate instrument does not imply that real exchange rates cannot appreciate or depreciate; and,

Second, that competitiveness adjustment risks being long and painful given the loss of the nominal exchange rate instrument.

As a result, real exchange rates in some EZ countries were allowed to become grossly over- or under-valued, creating difficult adjustment problems (see Levy 2012 for a related discussion).

Reduction the occurrence of asymmetric shocks in EZ
As Carlin (2013) emphasises, an important factor behind real exchange rate misalignment in the EZ, especially between the core and the periphery, is the difference in national wage formation and bargaining systems among its members. There is no easy solution to this problem.

The EZ cannot go forward with the degree of heterogeneity in national labour market institutions and outcomes that currently prevails
One solution would be to harmonise wage-setting systems but this hardly sounds feasible given that national wage-setting systems have deep historical, political, and social roots. The alternative is to broadly maintain the existing systems but to constrain their functioning to ensure that they produce outcomes which are compatible with membership of a monetary union and the need to avoid persistent real exchange rate misalignment. This requires mechanisms to prevent and correct substantial misalignments of competitiveness between EZ countries.

The Macroeconomic Imbalance Procedure (MIP), established by the EU in 2011 in response to the economic and financial crisis, could be an important tool to monitor and correct macroeconomic imbalances in all EU countries. This is especially the case for countries belonging to the EZ for whom the MIP contains an enforcement mechanism, including the potential use of sanctions. The MIP’s monitoring mechanism uses a set of indicators to assess macroeconomic imbalances and divergences in competitiveness.

In recent research, my co-author and I propose to complement the MIP by national procedures to monitor and, if needed, correct competitiveness problems and increase ownership at the national level (Sapir and Wolff 2015). These procedures would be required by EU legislation and their performance monitored by the European Commission.

All EZ countries would put in place a competitiveness-monitoring framework involving regular assessments and the definition of instruments to prevent problems. An interesting example is the Belgian legal framework, introduced in 1996 to preserve the country’s competitiveness in the EZ by keeping the evolution of wages in line with wage developments in its main trading partners. A national body regularly reports on the evolution of Belgian competitiveness. This assessment is used by social partners to fix a wage norm for the next round of wage negotiations. Although the norm amounts only to a non-binding guideline, it has generally been respected by the private sector (to which the system applies).
In case social partners fail to agree on a wage norm compatible with the evolution of competitiveness, the government can step in and make the norm legally binding. The system has worked fairly well – it left the wage formation and bargaining system that existed prior to the euro untouched, but made the behaviour of social partners compatible with membership of the euro. The result has been that unit labour costs in Belgium have evolved more-or-less in line with those in its main trading partners, thus avoiding significant competitiveness problems.

The Belgian system should not and cannot be exactly copied by other EZ countries, since they feature different wage-setting systems. What is important is that all EZ countries put in place a mechanism to ensure that, although operating within their own system, the behaviour of social partners and the outcome of their wage negotiations is compatible with membership of the euro, in terms of competitiveness and employment.

**Improving adjustment to asymmetric shocks in EZ**

The proposal to monitor and, possibly, correct labour competitiveness problems fits well with the Maastricht logic. This (implicitly) makes national authorities responsible for ensuring that national labour markets are sufficiently flexible to deal with asymmetric shocks. It also fits with the optimum currency area (OCA) literature which typically considers that the more a potential monetary union member risks being subject to asymmetric shocks, the more it needs labour market flexibility to compensate for the absence of the exchange rate instrument and adjust to such shocks (see, for instance, De Grauwe 2012).

However, the OCA literature never suggested that labour market flexibility, or even market flexibility in general, would be sufficient to deal with all asymmetric shocks. Instead it considered EZ-wide mechanisms to also be crucial, especially for big shocks. Two potential EZ mechanisms suggested by the OCA literature could have been labour mobility (as originally envisaged by Mundell 1961) or fiscal transfers (as first suggested by Kenen 1967) between EZ countries, but neither was promoted or put in place.
The Maastricht construction lacked one of the two adjustment mechanisms emphasised by the OCA theory – fiscal integration. The other mechanism, labour mobility, was theoretically possible by virtue of the EU treaties that guarantee the right of free movement of labour within the EU, but remained limited in practice.

The sovereign debt crisis came as a surprise. No one had foreseen that a EZ government could face a liquidity or even a solvency problem. As a result, the EZ contained no mechanism to deal with this crisis when it occurred. Several EZ countries found themselves suddenly unable to tap financial markets for their sovereign issuance and had to turn to supra-national public lenders.

One source was the IMF, but EZ countries needed their own rescue mechanism. They eventually created the European Financial Stability Facility (EFSF), a temporary mechanism later replaced by a permanent rescue mechanism, the European Stability Mechanism (ESM). EFSF/ESM loans come with conditionality that, so far, has always included making recipients’ labour markets more flexible. Hence, the new EZ regime set up in response to the financial and sovereign debt crisis includes an EZ risk-sharing mechanism in the form of fiscal assistance, along with structural reforms in product and labour markets.

Although this new regime is clearly better than the original EZ design it is still far from sufficient to provide the necessary adjustment within EZ.

What is still missing in terms of adjustment mechanism? Many support the notion that what the EZ needs is not so much a fiscal union per se, but an efficient risk-sharing mechanism that ensures both sufficient adjustment to asymmetric shocks and as little moral hazard as possible.

An international comparison of existing federations by the IMF shows that the EZ lacks the degree of risk sharing seen in other jurisdictions with respect to three dimensions (IMF 2014). First, contrary to federations such as the US,
Canada, or Germany, which manage to smooth about 80% of local shocks, the EZ only manages to insulate half of that amount. Second, fiscal insurance compensates 25% of local shocks in Canada, 15% in the US, and 10% in Germany. In the EZ, fiscal insurance was virtually nil before the creation of the EFSF/ESM and remains very small. Third, most of the risk sharing in federations happens through private channels, mainly capital markets and banks. The EZ is no exception, but the role of capital markets is much less than in other jurisdictions.

The previous discussion suggests that the distinction between fiscal insurance and private insurance through financial markets, and the fact that the latter typically plays the dominant role in smoothing local shocks in federations, is not an argument against the need for a EZ fiscal union. On the contrary, the fiscal union should not only provide direct fiscal insurance but also a fiscal backstop against financial risks to allow private insurance to fully operate (see Gros 2014).

Even if an efficient fiscal risk-sharing mechanism can be designed\(^1\), there is little chance that it will be implemented as long as the fear of moral hazard and of the related ‘permanent fiscal transfers’ is present in the EZ. This fear largely reflects the heterogeneity that continues to prevail among EZ countries. In this respect, the *Five Presidents’ Report* was right to emphasise that “there is significant divergence” across the EZ and that “completion of a successful process of economic convergence … would pave the way for some degree of public risk sharing” (Juncker 2015). What the Report has in mind is structural convergence predicated upon structural reforms geared towards “more efficient labour and product markets and stronger public institutions.”

In political terms, this suggests that the acceptance by (some) EZ countries of steps towards a fiscal union will only be possible if (other) countries undertake major structural reforms. Whether structural reforms should be left entirely in the hands of national authorities, or if they would benefit from EZ coordination as suggested by Draghi (2015), is an open question.
Conclusion
Let us be honest. The EZ cannot go forward with the degree of heterogeneity in national labour market institutions and outcomes that currently prevails. All members of the monetary union need to have institutions that ensure that wage developments are in line with productivity developments. This would eliminate an important source of asymmetric behaviour among EZ countries that can lead to painful adjustments.

At the same time, the EZ needs to put in place risk-sharing mechanisms capable of absorbing asymmetric shocks. Improving the functioning of capital markets in Europe would certainly be an important contribution towards that objective but fiscal mechanisms will also have a role to play. Yet there is much resistance in some countries to create EZ-wide fiscal mechanisms because they fear that structural weaknesses in other countries, in particular in the functioning of labour markets, will lead to structural rather than temporary fiscal transfers.

Reducing heterogeneity in labour market institutions and outcomes is therefore crucial for the sustainability of the EZ.

André Sapir is a Professor at Universite Libre de Bruxelles, Senior Fellow of Bruegel, Research Fellow of CEPR and member of European Commission’s Economic Policy Analysis Group

References
Draghi, M (2015) “Structural reforms, inflation and monetary policy”, Introductory speech by the President of the ECB, ECB Forum on Central Banking, Sintra, 22 May.

1. See Claeys et al (2014) for a discussion about the benefits and costs of a specific risk-sharing mechanism – European unemployment insurance.

A version of this piece was originally published on the Bruegel blog http://bruegel.org/2016/02/the-eurozone-needs-less-heterogeneity/