The Welfare State and the Future of the Eurozone
BY ROK SPRUK, ON MAY 13TH, 2010

The $140 billion rescue package to Greece is a milestone in the European Monetary Union. A lively debate on recent macroeconomic imbalances in the weakest economies of the Euroarea – Greece, Italy, Spain and Portugal – in the Eurozone has reopened the old debate on whether the Eurozone is an optimum currency area (here, here, here and here). The idea of optimum currency areas was first proposed by Nobel-winning economist Robert Mundell. In general, if several countries form a currency union, they should have at least four common macroeconomic features as essential framework of the currency union. In this article, I’ll review the labor market criteria and fiscal adjustment criteria in the light of a recent imbalances in the Euroarea, and leave production diversification and export criteria for future discussion.

First, there should be a high degree of labor mobility between countries in the currency union. The basic idea behind the labor mobility criteria is that the lack of labor mobility triggers divergence of productivity growth rates and asymmetric adjustment of wages. If inter-country productivity divergence persists, there is an upward pressure on wages adjustment given the lack of exchange rate adjustment since the countries share a common monetary policy. The formation of the currency union in the United States was relatively straightforward given the fact that labor mobility between the states is very high. In Europe, the level of labor mobility is relatively low. The lack of labor mobility has a lot to do with labor market institutions in European countries. Workers from the European periphery can hardly move to Germany, Netherlands or Denmark as they do not speak the same language. The lack of inter-country mobility resulted in significant wage premiums and rise in rents since European labor markets share a pretty high degree of monopoly power since European workers can’t switch easily between labor market structure. The resulting outcome of the lack of labor market competition was a significant “union capture” of the labor market, leading to rigid wage determination and high market switching costs.

Paul Krugman recently argued (link) that the major problem behind the European Monetary Union is the lack of common fiscal policy. To a very large extent, the absence of common fiscal policy seriously affects the future prospects of the European Monetary Union. Common fiscal policy could easily absorb asymmetric shocks within the Euroarea. However, instituting the policy could not alter the trade-off between fiscal autonomy and asymmetric shock intensity. In other words, the main problem of the Euroarea right now is the free-riding of Eurozone’s most problematic countries on a common monetary policy using discretionary fiscal policy. Before the economic crisis, Spain had a budget deficit while, at the moment, the 2010 budget deficit forecast is more than 8 percent of the GDP. The estimate Greece’s ballooning public debt in 2009 ranges from 110 to 115 percent, depending on the consensus forecast. If the EMU countries unified a fiscal policy, the countries would not have an incentive to free-ride on discretionary fiscal policy and further increase the stock of public debt. The major impediment on the recovery and long-term economic outlook of Eurozone countries is largely dependent on how these countries will reform the pension systems in the light of a growing old-age dependence and a near fiscal insolvency of the pay-as-you-go (PAYG) pension schemes. It will be impossible to reverse the aging population and its persistent pressure on an increasing public debt. The integration of fiscal policy would require a sizeable harmonization of taxes given high costs of coordination and sufficient incentives for moral hazard. Without the reversion of long-term public debt pressure from aging, discretionary spending and entitlements, countries such as Greece, Spain and Portugal would leave the Eurozone.

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