

Structural Heterogeneity and Partial Budgetary Cooperation in a Monetary Union

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Economics: The Open-Access, Open-Assessment E-Journal,
Discussion Paper, No. 2012-38 / August 15, 2012

Assessment by Fritz Breuss (WU Vienna), 25 September 2012

This excellent paper deals with a specific topic, namely the question whether budgetary cooperation, even between a limited number of structurally homogeneous members (partial cooperation) of a monetary union, is beneficial for the stabilization of various kinds of macroeconomic shocks. The main contribution of the paper is to show that structural heterogeneity between the member countries of the monetary union can affect the relative benefit of such a budgetary cooperation as regards the macroeconomic stabilization

After recapping the results of the paper I will check them to what extent it is suitable to solve the current Euro crisis. By doing so it turns out that the mathematically neat results demonstrate that they can only theoretically stabilize normal business cycle disturbances but are of limited value to tackle a big shock like that triggered by the debt crisis in Europe.

Plausible results

The main results confirm similar findings in the literature: Fiscal cooperation is generally efficient to stabilize symmetric shocks, whereas in case of asymmetric shocks one better refrains from any cooperation.

The specific results of the paper can be summarized as follows:

- (i) *Budgetary cooperation is beneficial to stabilize symmetric demand and supply shocks.* In case of demand shocks it is only beneficial between a group of countries in which the sensitivities of economic activity to public expenditures and to foreign economic activity are sufficiently high. In case of supply shocks cooperation is only successful when a sufficiently large number of member countries of the monetary union are involved.
- (ii) *Budgetary cooperation is often detrimental to stabilize asymmetric demand and supply shocks.* In case of demand shocks it is detrimental as soon as the sensitivity of economic activity to public expenditures is very small or very high in the group of cooperating countries, and if this group is very large. In case of supply shocks cooperation is useless, and even detrimental, if the structural heterogeneity (i.e. the reaction parameters differ between countries) in the monetary union concerns the sensitivity of economic activity to budgetary expenditures or to foreign economic activity.
- (iii) *Partial budgetary cooperation to stabilize the idiosyncratic supply shocks can be beneficial between a sufficiently large number of countries where the sensitivity of the exports to price-competitiveness is high enough.*

No doubt, this excellent paper adds to the literature about how to optimize the policy-mix in a monetary union insofar as it deals specifically with heterogeneity of the member states. In the review of the existing literature, however, the author neglects some more recent papers dealing also with heterogeneity in their cooperation exercises by using world macroeconomic models (with country specific reaction parameters and spill-overs between the countries within or outside the monetary union). I will just mention Neck-Haber-McKibbin (2005). They get a rich bouquet of results for different kinds of cooperation: only fiscal cooperation (like in the present paper), monetary and fiscal cooperation (“full” cooperation), non-cooperation etc.

Assumptions with limited real life value

The weakness of the paper for practical policy advices arises from the narrow set of *assumptions*. The author derives its (mathematically tricky) results only from two equations (one for aggregate demand and one for aggregate supply – an enhanced Lucas supply function) and two loss functions (one for the government – budgetary policy; one for the central bank – monetary policy). It is assumed that budgetary authorities (the governments) are “Stackelberg leaders”. Well in the current Euro crisis it seems that this does not mirror the real situation of the current crisis management of the representatives of the Euro zone. Either it seems (in particular after the announcement of the new OMT policy by the ECB) that in times of crisis the monetary policy of the ECB can react much quicker than the budgetary policy (including the debt management via the new rescue mechanism EFSF/ESM) of the member states of EMU; the latter are constraint by time-consuming democratic decision mechanism.

The author applies a (very simple) dynamic New Keynesian model (a two-equation model!) of a closed monetary union (no spill-overs to the rest of the world but real-economy spill-overs between members of the monetary union) with two groups of countries. One group consists of homogeneous countries (call it the “North-EMU”) which prefer a “reinforced (fiscal) cooperation” (e.g. in the present situation with the Sixpack and the Fiscal compact). The second group would rather like to keep their full budgetary autonomy (call it the “South-EMU”). Both groups are heterogeneous concerning the reaction parameters. Comparing this simplified model-setup with the current Euro crisis one easily sees that essential ingredients are neglected such as the rapid increase of government bond spreads (signalling default risks in the Euro periphery) since the outbreak of the global economic and financial crisis 2008/09.

The specificity of the Euro crisis is not captured in the model

Shocks are specified in this paper – like in the traditional literature on policy coordination – as artificial disturbance terms to the demand and supply equations. One does not know what stands behind them or which story they have. In normal times such shocks simply create (randomly) business cycles. In time of crisis like that of the Euro crisis since early 2010, when Greece was nearly bankrupt traditional macroeconomics has its limits. Now the task is not to stabilize via public expenditures some of the Euro zone economies (or the whole Euro zone) because they were hit by small and ordinary demand and/or supply shocks in the real economy.

In contrast, since 2010 we live in a so-called “Reinhart-Rogoff regime” where some Euro zone countries in the periphery accumulated public debt above the “Reinhart-Rogoff” benchmark of 90% of GDP. The increasing default risk and the downgrading by rating agencies pushed up the yield of public bonds far above the “death zone” of 7% where public financing is no longer sustainable and bail-out mechanism by Euro zone partners must help. Thinking in traditional macro-model categories the real sector spill-overs the explosive power of contagion of the Euro crisis would not emerge. With its tiny share the Greek economy would hardly provoke via trade linkages a Euro zone crisis. But the (in practically all macro-models so far neglected) financial interrelations explain the explosiveness of the Euro crisis. The banks of the Nord-EMU are creditors of considerable amounts of public debt of the periphery countries. So via the financial linkages (possible contagion) the shock waves in the Euro zone spark the Euro crisis and not simple real sector shocks via trade linkages.

The Euro crisis is the result of two kinds of causes: (i) the increasing divergence of competitiveness between the Nord and the South of the Euro area since the inception of EMU

in 1999, resulting in macro-economic disequilibria (e.g. in the current account) ; (ii) the accumulation of private debt (causing housing bubbles in Ireland and Spain) and public debt (in Greece, Italy and Portugal). For the increase in the heterogeneity of competitiveness the periphery countries are to blame because they failed to properly adjust their wage policy to a situation with a single currency. The over-indebtedness is also a consequence of the single monetary policy for a non-homogeneous Euro zone (the missing “European business cycle”) – one interest rate does not fit for all countries. The too low interest rates in the periphery countries led to misallocation of capital in the private sector (construction and housing) and the public sector (too expansionary budgetary policy).

Which kind of cooperation?

The debt disturbances are so big in the Euro zone that traditional cooperation exercises are not very helpful in stabilizing or even solving the debt crisis. New instruments – rescue or bail-out instruments like EFSF/ESM – are needed and were already installed (partially in breaching the “no-bail out clause” of Article 125 of the EU Treaty) and even further mutualisation of the public debts in Greece and other periphery countries (via additional haircuts or a redemption fund) must be envisaged.

In case of big crises, therefore the exercise of only budgetary cooperation is of limited value. We would also need a “full” cooperation, one between the budgetary authorities (say via ESM) and the monetary authority (the ECB). A first step is made in this direction with the conditioned Outright Monetary Transactions (OMTs) policy announced by the ECB on 6 September 2012. Many previous studies (also that of Neck-Haber-McKibbin, 2005) underline that a “full” cooperation would be welfare optimal. However, the EMU policy design, based on the Maastricht and the following Treaties is based on a strict separation: the central monetary policy of the ECB acts independently of the decentralized fiscal policy, coordinated with such instruments as the Stability and Growth Pact (SGP). Due to the limited success it was reformed by the “Sixpack” after the break-out of the Euro crisis.

Resumé

The paper by Séverine Menguy is an excellent study in the area of economic policy coordination. It deals exclusively with fiscal (budgetary) policy coordination within a monetary union under the condition of structural heterogeneity of its members. The author derives clear-cut results concerning the stabilization properties of budgetary cooperation in case of symmetric and asymmetric demand and supply shocks in the real economy. Without criticising the approach and the execution of the theoretical model I have tried to confront its theoretical results with the specific shocks involved in real life crises like that of the current Euro crisis. By doing so it turns out that this paper has no answer to the manifold of the crisis (over indebtedness, macro-economic imbalances, and the danger of a possible break-up of the Euro zone). But this is not the fault of this study alone but is the general problem with pre-crisis macroeconomic models which fitted nicely in “fine weather” periods but are of no help to explain and solve unique crises like the one we are confronted with in Europe today. We are in search for a new “Keynes” or more modestly we are looking for a new macroeconomic paradigm.

Reference:

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