Standard Life Investments

Weekly Economic Briefing
Global Overview

The sub-optimal currency union

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Greece has been granted a four-month stay of execution. But the threat of Grexit has not been removed and whether the country's destiny lies inside or outside the Eurozone will depend on the polity's ability to withstand many more years of fiscal and structural adjustment. There is a long list of reasons why Greece finds itself in its current predicament. Corrupt public account keeping, excessively rigid labour and product markets, insufficient oversight of cross-border lending and capital flows, and the design of the post-crisis adjustment programme, to name a few. More fundamentally, however, the fault lies with the design of the currency union itself. There is a large economic literature identifying the conditions that should hold for a group of countries to be better off sharing a currency. These include: a large degree of trade and labour market integration; a high correlation between domestic business cycles; and strong, centralised economic and financial supervisory institutions that help to mitigate the effect of any shocks that impact member countries differently.

Some of these conditions were met when the European Monetary Union (EMU) was instituted. Goods trade integration was high and domestic business cycles were influenced by the overall European cycle. But many were not. Services trade and labour market integration were weak. Countries were subject to asymmetric shocks. And in the presence of those shocks, European fiscal and regulatory institutions were not strong enough to reduce their intensity. In Greece's case, as with other countries, too much capital flowed into the country in the pre-crisis years and that capital was allocated inefficiently (see Chart 1). When things went wrong, the country did not benefit from significant fiscal transfers, and the solvency problems of its banks became too intertwined with the solvency of the government. Contrast that with the United States, where large fiscal transfers and the national regulation of its banks shielded states like Florida, Nevada and California from the full effects of the crisis. There is a reason why we never talk about Florexit. The Eurozone has made some institutional progress since the crisis but it is not sufficient to prevent future shocks from having unnecessarily large and systemic negative effects.

Chart 1: Divergence rather than convergence

Contributors

Authors:
James McCann
Jeremy Lawson
Govinda Finn
Alex Wolf

Editors:
Jeremy Lawson
James McCann

Chart Editor:
Craig Hoyda

Contact:
Jeremy Lawson,
Chief Economist
jeremy_lawson@standardlife.com

The rise of the union

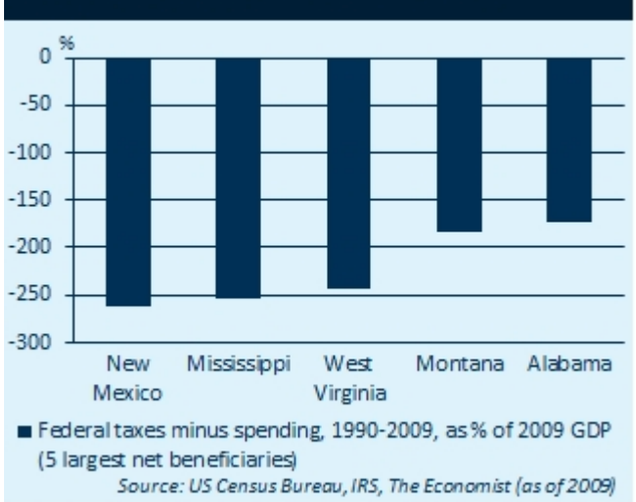
The United States is held up as an example to the Eurozone of what an optimal currency union should look like. This economy has all the right ingredients – integrated trade, labour mobility, inbuilt mechanisms for fiscal transfers and centralised financial supervisory institutions. **These factors allow different regions to adjust to unanticipated shocks in the absence of an independent monetary policy or exchange rate**. This generates a number of benefits, including reduced transaction costs and currency risk in a large, flexible single market. What can Europe learn from this institutional arrangement?

To start it might look at the role that fiscal transfers play. US taxes collected at the federal level have averaged 17% of GDP over the past 50 years, compared to the 1% collected by the European Union. This makes it possible to finance large fiscal transfers between individual states through a progressive tax system (see Chart 2). States with lower average incomes are taxed less and receive a greater share of Federal spending. These transfers are amplified in the case of an economic shock. Research by the LSE finds that for every dollar the level of GDP falls in a state, federal taxes collected there are reduced by 55 cents. Federal spending also responds to these shocks through higher unemployment insurance payments. **These mechanisms help to soften the impact of local economic shocks, preventing these from pushing the area too far out of step with the rest of the union**.

The recent oil price declines should provide an example of how local shocks can be muted in an optimal currency union. While lower oil prices should be a net benefit for the US economy as a whole, they will harm oil producers. These tend to be clustered in certain states, with Texas and Dakota alone providing half of US oil production. Lower prices should lead to reduced investment and employment in this sector, which will feed through to associated industries and services. Indeed, we have already seen a sharp decline in the US oil rig count, with Texas topping the chart in terms of closures (see Chart 3). The fiscal transfers listed above will partly cushion this blow. **The relative mobility of the US labour force should also help**. Empirical evidence shows sharp rises in inter-state mobility following regional shocks in the US. This might explain why the differences in state unemployment rates in the US are relatively muted with unemployment highest in DC (7.3%) and lowest in North Dakota (2.8%). When we compare to a Eurozone differential of 25.8% in Greece and 4.8% in Germany, the shortcomings become quickly apparent. Labour mobility forms another key reason why the US currency union works.

In many ways, the US example illustrates how much work is required to create an optimal currency union. However, a historical footnote is required here. The United States did not become a currency union overnight. Indeed, a recent paper by the National Bureau of Economic Research argues that the US did not in fact meet these criteria until the 1930s, when institutional changes such as increased federal fiscal transfers and bank deposit insurance were introduced. **Following this timeline, the Eurozone looks to be ahead, rather than behind schedule, although it is unlikely to enjoy the luxury of 150 years to get it right!**

Chart 2: The fiscal transfer winners



Source: US Census Bureau, IRS, The Economist (as of 2009)

Chart 3: Pockets of distress

Source: Baker Hughes, Datastream (as of 20 February 2015)

So much for game theory

The Greek government and the Eurogroup finally hammered out a deal on Friday that will extend the review of the troubled country's bailout programme by another four months. This will enable Greece's banks to retain their access to the ECB's Emergency Liquidity Assistance, which should at least slow the deposit outflows that were threatening to bring the financial system down and force the country out of the currency union (see Chart 6). The "institutions" – the new name for the Troika – have also agreed to take Greece's precarious economic circumstances into account when re-setting this year's primary fiscal surplus target. **In return for the temporary extension of the programme review and additional near-term fiscal flexibility, the Greek government has agreed to a number of difficult undertakings**: meeting all of their financial obligations to their creditors; running large enough primary fiscal surpluses and privatisation programmes to guarantee debt sustainability; implementing structural reforms to improve growth and employment prospects; increasing the resilience of the financial sector; enhancing social fairness; tackling corruption; tax evasion and improving the efficiency of the public sector; and refraining from rolling back or changing any of the previously implemented policies and reforms that would negatively impact Greece's fiscal targets, economic prospects or financial stability. The Greek government now has to propose a set of new reforms that have to be agreed with the institutions by the end of April. Only then will the outstanding EFSF funds be disbursed.

Reading between the lines, this temporary agreement mostly represents a capitulation on Syriza's part. Greece is likely to obtain a modest debt re-profiling after June, as long as the two sides can agree on future fiscal and reform measures. They will also benefit from a lower primary surplus target for 2015, though exactly how much is still up for discussion. We doubt that anything above 1% of GDP (the original target was 3%) is even feasible, given the recent collapse in government revenue (see Chart 7). However, **Greece is likely to be granted less fiscal leeway in 2016 and beyond, which implies that further austerity is coming**. A lot will therefore be riding on Syriza's crackdown on tax evasion. The less successful that is, the more they will have to raise taxes and cut spending elsewhere. Moreover, **the government's room for manoeuvre on structural reforms is also going to be limited**. While Prime Minister Tsiparas is highlighting the government's right to propose new reforms, the text of the agreement was careful to specify that they will have to be growth and employment friendly. The institutions will not allow Greece's labour market to be re-regulated, which means that much of the government's domestic policy agenda is effectively dead. Moreover, the four-month extension was clearly chosen to hold the government's feet to the fire before July and August's large bond redemptions are due. Failure to comply with the terms of the agreement, or agree to the appropriate set of future reforms and fiscal targets means no financial assistance. Just as importantly, **the government is going to have a hard time selling this deal to its party, coalition partner and the broader electorate. They will be a socialist government forced to implement a liberal reform agenda they vehemently opposed**. Thus, not only is there a risk that the agreement breaks down, but the stability of the government itself cannot be guaranteed. Grexit risk has been delayed but not eliminated.

Chart 6: Capital flight

Chart 7: Missed targets