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ADJUSTMENT TO ADVERSE SHOCKS WITHOUT EXCHANGE RATE CHANGES⁴⁶

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Abstract: *This paper investigates the possibilities the economies to adjust to adverse shocks in the absence of exchange rate changes. It is discussed how labour market flexibility through lower labour costs contributes to a decrease in the relative price level of domestic to foreign goods. Moreover labour mobility can alleviate the effects of a region or country specific shock. The second way of adjustment in the absence of exchange rate instrument is through external financing. Having already liberalized the capital account transactions, by adopting the Euro the EMU countries remove some of the limitations on the acquisition of foreign financial assets and liabilities. An adequate budgetary policy could further help national economies to counteract adverse shocks without exchange rate changes.*

Keywords: *Exchange rate, Labour flexibility, Budgetary Policy, EMU*

JEL Codes: *F15, F31, F36, F43*

INTRODUCTION

In the absence of exchange rate changes, the adjustment to an adverse asymmetric shock can be made through labour market flexibility, external financing or budgetary policy. Referring to the first adjustment possibility, the effects of an asymmetric shock can be countered by two market-clearing ways, in addition to the effect of profit margins. The first is through lower labour costs, which contribute to a decrease in the relative price level of domestic to foreign goods. The second mechanism refers to labour mobility, which can alleviate the effects of a region or country specific shock. The adequate budgetary policy can further contribute to counteracting the adverse asymmetric shocks.

EXPOSITION

Studies for current EMU countries (Maksymenko, 2015) showed rather insignificant response of unit labour costs to unemployment differential within countries. An argument which goes for an enhanced real wage flexibility in the case of EMU membership refers to the fact that in a more integrated product market, the degree of monopoly of individual suppliers decreases the product demand, so consequently labour demand, is more elastic. Moreover, an important factor influencing the flexibility of the wages is the wage determination process; thus, rigidity seems to be the highest under intermediate forms of centralization of wage bargaining, suggesting a hump-shaped relationship between these two factors (Buitier, 2002).

Due to a combination of language/cultural barriers and different levels of social security, the current evidence *does not suggest* that regional mobility within current EMU would be large enough to

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bear a significant proportion of an adjustment to a regional specific shock (Calvo, 2002). Moreover, political considerations (in the case of regional migration) and welfare considerations (in case of wage flexibility) will put another limit on this adjustment instrument.

Labour mobility contributes to a better allocation of resources and thus leads to enhanced economic efficiency. An economically motivated European immigration policy can generate high welfare improvements. A selective policy that discourages unskilled migrants and attracts skilled foreign workers will vitalize the labour market, foster growth and increase demand for unskilled native workers. Their wages will increase and their unemployment rates will decrease, respectively. The variety of migrant work skills improves the host country's response to turbulences on its labour market and thus counteracts adverse shocks (Zimmermann, 2005).

The labour mobility affects the dynamic adjustment of the economy, in response to unanticipated shocks. The labour mobility reduces the variability of the real exchange rate following each shock. However, labour mobility can affect economic growth depending upon the nature of the unanticipated shock. Open economies facing asymmetric shocks could have different approaches to asymmetric shocks. Countries exposed to asset-market shocks are likely to lose from labour mobility and could counteract by suppressing labour mobility. Those countries exposed to goods-market shocks could profit from labour mobility and could try to adopt measures stimulating labour mobility (Agiomirgianakisa, 2001).

A recent research of the impact of the coronavirus on economic growth has revealed that a 10% drop in mobility is associated, on average, with 2 percentage points lower GDP growth, with no systematic differences observed between advanced economies and emerging markets (Gamtkitsulashvili, 2021). The stronger-than-expected economic performance of European economies in the second half of 2020 and the early months of 2021 can thus to a large extent be attributed to enhanced labour mobility (compared with the second quarter of 2020).

External financing

A second way of adjustment in the absence of exchange rate instrument is through *external financing*. Having already liberalized the capital account transactions, by adopting the Euro the CEE countries will remove some of the limitations on the acquisition of foreign financial assets and liabilities. Exchange rate influences the real exchange rates and the import prices, increasing the variability of macroeconomic variables.

The economic growth is closely connected to the quantity of the net flows of capital into a region. Regional output growth and private net flows, measured as a proportion of GDP, are positively correlated (34%). The notorious volatility of these net flows is associated with the high growth volatility (Calvo, 2001). The external financing facilitates the enhancement of production productivity. This further gives opportunity for improved exporting capabilities of the firms. Exporting could improve access to external financing through cash flows derived from the international diversification of sales and thus lower exposure to demand-side shocks (Bridges, 2008). Exporting gives the possibility to use external financing from international financial markets.

The exporting enterprises enjoy better financial health than the ones that do not export (Greenaway, 2007). The exporters with little experience, though, are the ones who have liquidity challenges maybe due to the sunk costs of the initial entering the international markets. As whole there is strong consistency in improvement of the financial health of exporters. Financial health of firms enhances the chance of enterprises to initiate exports (Berman, 2010). Their work shows that

the state of financial health does not correlate with the continuity and the size of export. However, the correlation between productivity and external financing is strong and evident.

The results demonstrate the importance of financing for promoting innovation, by showing that some sources of external financing used in one year seem to be more effective than others in stimulating innovation in the subsequent year. Equity financing has a larger effect on the strategic decision to innovate, and the highest output additionality on firm turnover growth, when compared to the effects of other sources of financing. Grants registered a moderate effect on innovation and on output additionality on firm growth (both turnover and employment). Furthermore, grants appear increasing more employment than turnover. Nevertheless, the number of financing instruments used together also seems to matter, and a financing instrument used alone has no effect on innovation (Santos, 2019).

Budgetary policy and economic growth

Countercyclical macroeconomic policies, with higher government investment or lower nominal interest rates during recessions, may foster productivity growth by reducing the magnitude of the output loss induced by market failures (in particular, by credit market imperfections) in a recession, which in turn should allow credit-constrained firms to preserve their growth-enhancing investments over the business cycle (Aghion, 2010). During a recession, unemployment grows and the workers' earnings drop. Government expenditures could suppress that issue directly by social programs, or indirectly, by stimulating labour demand and therefore employment; this relaxation of credit constraints, in turn, would allow workers to make growth-enhancing investments in human capital, relocation, and so on.

However, there is a negative impact of public consumption and social security contributions on economic growth, and a positive impact of public investment. The budget deficit has a positive effect on long-term growth, even if it is not always statistically significant. The main impact of fiscal variables comes through changes in the pattern of investment of the economy. Higher government spending leads to an increase in private sector investment. This in turn, provokes an overall positive effect of public investment on economic growth, despite its negative impact on multifactor productivity. Social expenditures and public investment seem to affect the labour market while public consumption and public wages have a significant impact in multifactor productivity (Afonso, 2011)

CONCLUSION

The paper shows that there are possibilities to counteract adverse asymmetric shocks without being necessary to interfere with the exchange rates. This can be done by the labour market flexibility encouraging or discouraging labour mobility. The correlation between productivity and external financing is strong and evident. It stimulates employment, innovation and thus enhances economic growth. Higher government spending contributes to a rise of investment in the private sector. The large influx of money in the private sector provokes an overall positive effect of public investment on economic growth.

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