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DIFFERENCES BETWEEN COUNTRIES WHICH CAN BE CORRECTED WITH AN INDEPENDENT MONETARY POLICY⁵⁰

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Abstract: *The shift of demand between countries and the different approach of each country to inflation and unemployment, as well as the country specific legal systems trigger processes unique for each of the countries. The difference in growth rates stimulates some countries to depreciate their currencies. The goal of this paper is to find out which cross national differences can be corrected with an independent monetary policy and if there is a necessity to join a monetary union.*

Keywords: *Independent Monetary Policy, Common Monetary Policy.*

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INTRODUCTION

There are several reasons for which the exchange rate can be considered an instrument of correcting differences between countries, not only from a theoretical but also empirical point of view. These are *shifts in demand, different preferences of countries for inflation and unemployment, differences in legal systems, unequal growth rates and different fiscal systems*. The introduction of the euro as a single currency in 2002 in EMU is a test for the creation of an *Optimal Currency Area (OCA)* in Europe.

EXPOSITION

Shift of demand from goods produced in one country to goods produced in another country

The *shift of demand* from goods produced in one country to goods produced in another country causes the domestic output to decline, the employment to decrease and the current account deficit to rise in the first country, while the second one will have the opposite processes (Mundell, 1961). The equilibrium can be re-established by a wage decrease in the first country, labour force transition to the second country or a net fiscal transfer from the first country to the other one. However, if wages are rigid and if labour mobility is limited, the devaluation of the currency of the country hit by the adverse shock may shift the demand back to its original level in both countries. Thus, according to Mundell's theory, the effects of these demand shifts will solve the unemployment problem in the first country and the second country will avoid inflationary pressures.

Relinquishment of the control over exchange rates

If the two countries abandon the control over their exchange rates by joining a monetary union, then the country suffering a negative demand shock will experience a sustained unemployment problem, while the second country will have to accept higher inflation than desirable. To put it differently, the conclusion of Mundell's model is that a monetary union between two or more countries is optimal if one of the following conditions-is satisfied:

- (a) There is sufficient wage flexibility and:

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(b) There is sufficient mobility of labour. Workers from countries with high unemployment can move to regions with lower unemployment, until the former obtain competitive advantage. The intensive mobility of labour can mitigate an increase in unemployment or a drop in activity rates in countries affected by the adverse shock (Arpaia, 2018).

(c) Sufficiently centralized budgetary process which helps a monetary union to function and should allow for smooth fiscal transfers between the countries of the union (Bayoumi, 1996).

(d) The Mundell's standard Optimal Currency Area theory highlights the significance of homogeneity, in business cycle synchronization, among the countries that want to establish a currency area (Giannone, 2010).

Recent research shows, however that there are other factors contributing to the optimal monetary union:

(e) Price flexibility. The price flexibility is an important shock absorber in the EMU compared to the United States. The scientific results prove that the short-term response of prices is larger (by almost 5 times) in the EMU than in the United States (Furceri, 2020).

(f) Financial integration. Recently, there is an increased shock absorption capacity in EMU countries due to a higher financial integration, but also to the activation of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) channelling official loans to distressed euro zone economies (Chari, 2020).

Different preferences of countries about inflation and unemployment

Different preferences of countries about inflation and unemployment constitute another reason for which a flexible exchange rate regime might be desirable. The fact that some countries are less allergic to inflation than others may make the introduction of a common currency costly (Bayoumi, 1996). The purchasing power parity demonstrates that if a country has a higher rate of inflation than another one, then it will need to depreciate its currency to maintain the competitiveness of its products unchanged. However, if the two countries are forming a monetary union and have different inflation rates, the fixed exchange rate will be unsustainable. The cost of a monetary union for the two countries will be that they will have to choose another (less preferred) point on their Phillips curves. It is now generally accepted that the Phillips curve is not stable, i.e. that it shifts upward when expectations of inflation increase. Thus, a country that chooses a too high inflation rate will experience an upward shift in its Phillips curve. Therefore, the authorities will have little free choice between inflation and unemployment. Nowadays it is generally accepted that the Phillips curve is a vertical line in the long run (De Grauwe, 2000).

Differences in legal systems

Differences in legal systems are a reason for which relinquishing the independent monetary policy in a monetary union might be costly for the participating countries. Despite decades of integration in the EU, the member states continue to have very different legal systems. An example is the way the mortgage markets operate. Because law protects banks in some countries better than in others, mortgages are different products with different degrees of risk from one country of EU to the other. Legal differences also lead to different frequency of adjusting the interest rate. Consequently, an increase in the interest rate by ECB will be transmitted very differently across the member states of the union. In countries with an Anglo-Saxon legal tradition, firms tend to go directly to the capital market by issuing bonds and shares. In countries with continental legal tradition, firms attract resources mainly through the banking system. Therefore, in countries with an Anglo-Saxon type of financial system, an increase in the interest rate will have large effect on the welfare of consumers. However, in countries with continental - type financial markets, the interest rate increase will affect spending of consumers mainly through the bank-lending channel. Thus, the transmission of interest rate changes into consumption and investment spending might be very different across EMU members.

Growth rates differences across EU members

The difference in growth rates in the last decade is even more noticeable between the CEE countries (who are experiencing a catch-up process) and current EMU members. Assuming an income elasticity of imports equal to one, this means that imports of higher growing countries will rise at a higher pace than imports of slower growing countries. This in turn will lead to a trade imbalance for the CEE countries. In order to avoid chronic deficits, especially under the COVID 19 reality, these countries might benefit from depreciating their currencies. However, if all of them share the same currency, the CEE high-growing countries will have to follow deflationary policies, which in turn might constraint the growth process.

Different fiscal systems

These differences encourage countries to use different combinations of debt and monetary financing of the government budget deficit, if possible, at all (countries like Bulgaria, which have a currency board, have little to no possibility to use monetary policy). As rational governments will use the two different sources of revenue so that the marginal cost of raising revenue through these different means is equalized, countries will have different optimal inflation rates. Thus, countries with tax systems undergoing changes will find it more advantageous to raise revenue by inflation or seigniorage. Following the accession to a monetary union, countries will have to lower their inflation and to increase their taxes most probably. This would lead to experiencing a loss of welfare if they decide to maintain the same level of spending.

Optimal currency area (OCA)

Numerous studies have been done in order to explore the OCA in Europe and the USA. The USA is one of the earliest examples of a monetary union. It took the United States 150 years to become an OCA, and this happened only after strong institutional steps such as the introduction of interregional transfers (Rockoff, 2000).

A recent study (Coudert, 2020) involves on one hand, Belgium, France, Germany, Ireland, and the Netherlands which form the most homogenous group; on the other hand, two pairs of countries, namely Austria-Finland and Spain-Italy, constitute a second group. Portugal and Greece show different equilibrium exchange rate paths; Greece being the most idiosyncratic country, because of its structural weaknesses regarding the financing of its economy. The study demonstrates that countries did not converge structurally. The introduction of the euro in the first 10 years fuelled consumption and real estate demand in the peripheral countries without any significant enhancement of production going parallel. The conditions of OCA are not automatically fulfilled with a mere introduction of a monetary union. A common fiscal policy of the EU would be beneficial to the establishment of an OCA in Europe. The process of redistributing EU funds to the peripheral especially southern EU members would further contribute to the convergence of these regions.

CONCLUSION

The issue whether a country should join a monetary union is definitely a difficult one. On one hand, the relinquishment of the control over exchange rates and the abandoning of an independent monetary policies might push the new comers to uneasy and unpopular decisions to follow deflationary policies and/or increase taxes which might in turn affect the welfare negatively. On the other hand the financial integration in the EMU has increased shock absorption capacity in the EMU countries also because of the activation of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) channelling official loans to distressed euro zone economies. The OCA offers long term advantages for the single currency to provide the best balance of economies of scale to a currency and effectiveness of macroeconomic policy to promote growth and stability. The process of creation of an OCA is, however, a lengthy one.

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