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EMU AND THE NEW "STABILIZATION STATE": DEMAND DISTURBANCES AND ASYMMETRIC RESPONSES

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ABSTRACT

Despite its important advantages of efficiency gains, price transparency, monetary stability, easing currency markets pressure on the payments balance, and so on, EMU is anything but a risk-free enterprise. Economic conflict may arise from unfortunate developments regarding the Euro, which may provoke political disharmony, disputes between member-states, and destabilization. The deteriorating trade performance of the European periphery is one issue. Asymmetrical demand disturbances is another, especially as labor markets remain largely rigid. Eurozone mechanisms may be unable to face demand disturbances under a single currency regime, which could also debilitate production systems and so diminish trade in lagging regions. Under the Eurozone institutional architecture, the erosion of fiscal policy and inability to successfully handle asymmetric shocks will reflect negatively on the sociopolitical stability and legitimacy of EMU. The inherent asymmetry of potential economic disturbances in the Eurozone can only be countered by asymmetric policy responses, corresponding to different socioeconomic and structural endowments of member states. The Eurozone configuration favors if not necessitates a state committed to stabilization, but this new stabilization state's foremost feature is flexibility, at micro- and macroeconomic level, including the role of a partner and catalyst of developmental policies, and facilitator of social pacts.

INTRODUCTION

The replacement of national notes and coins by the Euro is said to benefit national economies by reducing uncertainty on interest rates and exchange rates, providing a better exchange for tourists and industry, diminishing red tape created by banks, abolishing transaction costs, promoting trade and establishing a strong and stable currency, guaranteed by the European Central Bank (Emerson et al. 1992). Euro, as argued, will also allow in the near future better access to markets within and outside the EU for European enterprizes raising their competitiveness, while, on the other hand, this process will promote benefits

such as price transparency for the European consumers. Pro-European professional economists, politicians and policymakers also argue that the Euro will bring higher growth rates, which will help reduce unemployment.

On the other hand, skepticism about the economic shortcomings of the Euro mainly draws on the theory of Optimum Currency Areas (OCA) (Mundell 1961) which comes down against a common monetary policy. The mobility of the factors of production across Europe – the antidote to asymmetric demand shocks according to the OCA theory—namely labor and capital, seems not to have increased and still remains at low levels. The funds going to disadvantaged regions and cohesion countries, the so-called European fiscal stabilizer, are still less than the aid needed for economic activity to be restored near full employment. It is thus argued that Europe does not fulfill the basic conditions to be an OCA and the costs of a single currency, mainly output loss and high unemployment, are said to be too high to offset the benefits, at least in the short-term.

Even if the criteria of OCA theory are not met in the European case, the purpose of this paper is not to argue against the Euro. Criticism concerning the deficiencies of the single currency has only the purpose of laying the groundwork for future improvement by giving policymakers available options to handle unfortunate situations. Moreover, as many observers believe, the new "credibility paradigm" has shed light on aspects neglected by OCA. According to this paradigm, devaluation is not such a flexible policy instrument as OCA implies and there are also certain limits in correcting demand disturbances in an economy by using the exchange rate instrument (De Grauwe 2000). However, it is indisputable that the 1990s bequeathed Europe with unacceptably high unemployment rates and a relatively significant proportion of the population below poverty line. These unfortunate developments have shaken the faith of Europeans in the ideal of a unified, efficient but also "social Europe", to such an extent that in a number of countries EMU supporters could constitute a minority in the near future.

It is thus important to diagnose today's sources of conflicts so as to respond in time with appropriate policies to lead to a prosperous EMU, by mitigating unfortunate conditions that could spread Euro-pessimism. A possible failure to face the problems could also shake the ECB's efforts to establish the Euro as an international vehicle currency, let alone the longer-term ambition of turning it into a reserve currency.

Section 1 deals with the conflicts arising from persisting asymmetry of demand shocks, possible unfavorable effects on trade and welfare, lack of national and supranational fiscal stabilizers, low mobility and flexibility of labor, and shortage of money stocks for the peripheral countries. Section 2 outlines the asymmetry and flexibility of policy responses as crucial features of the new "stabilization state" that will possibly allow it to confront asymmetric socioeconomic disturbances resulting from the Eurozone architecture.

1. Potential Sources of Conflicts

1.1 Asymmetry of Demand Disturbances Shift the Burden of Adjustment to the Country in Disequilibrium

The first point refers to the possibility of disagreements about the goals and methods of monetary policy, now fully implemented by the ECB. The very first requirement to form an

OCA lies in the incidence and magnitude of the idiosyncratic demand disturbances which individual countries experience as well as in the speed of adjustment (Eichengreen 1997). For an open economy, demand disturbances depend also on foreign market fluctuations and changes in imported oil prices. Asymmetry in demand disturbances across regions and countries comes mainly from differences in the mix of products they produce. Other things equal, the product specialization of individual countries, determines both the incidence and magnitude of demand disturbances and so it constitutes a first credible factor to decide whether a currency area is optimum or not. Brussels officials insist on the ability of the EMU to converge structures of production within the EU (Emerson et al. 1992). However, economic theory leaves no doubt that the deeper the market/trade integration, the higher the sectoral specialization and the division of labor (Krugman and Obstfeld 1994).[1] Furthermore, the greater the difference in the structure of production, the greater the incidence and the magnitude of the demand shocks that individual countries and/or peripheries experience, and thus the lower their speed of adjustment, if any, in the case labor markets remain rigid.[2] Eichengreen (1997) provides evidence that core EU countries (Germany, France, the Netherlands and Denmark) experience very different supply shocks from those affecting other member-states such as the UK, Italy, Spain, Ireland, Portugal, and Greece.

In a case with multiple countries and currencies, governments are able to use demand management policies to face idiosyncratic shocks, namely succeed in adjustment by applying accommodating monetary policies and using the exchange rate instrument to correct external disequilibrium. Currency can depreciate to lower relative prices and underpin demand or it can devalue. The greater the asymmetric shock, the higher the option value of independent domestic monetary and exchange rate policy. However, EMU, by definition, involves a sacrifice of monetary authority, and Eurozone authority for the implementation of a single and non-differentiated monetary policy now belongs to the ECB. As economic integration proceeds and diversity of production structures deepens across Europe, a negative aggregate demand shock is expected to have differential, heterogeneous impact on member-states and/or European regions. In that case, the cost of adjustment within Eurozone will depend on the size and incidence of asymmetric real shocks, as well as on the efficacy of the alternative adjustment mechanisms, namely, labor market mobility/flexibility and fiscal policies (Obstfeld 1997). Otherwise, the country hit by shock must deflate internally by lowering its wages, accepting unemployment and economic recession.

Empirical evidence by now has shown that asymmetries between core and peripheral countries in Europe persist (Bordo and Jonung 1999; Krueger 2000; Obstfeld 2000; Dunn 2001) and that they coexist with non-synchronized business cycles among member-states.[3] Therefore, as the asymmetry of demand shocks raises regional unemployment by destroying industries and jobs, there is a need for monetary accommodation (i.e. increase of money supply and lower interest rates) to offset fluctuations and restore growth and employment. For

[1] Manufacturing employment in Germany, France, UK and Italy is in double-digit numbers (with Germany around 30%) while in Greece, Portugal, Ireland, Denmark, Luxembourg and Belgium employment in manufacturing is around 1-3% of total employment (Eurostat Yearbook 2001). The differences in production structures are, thus, evident, rendering member-states subject to differential shocks.

[2] McKinnon (2000) mentions that the composition of output varies from one country to another, leading member-states to experience terms-of-trade shocks differentially. So the loss of domestic monetary control is expected to make macroeconomic shocks more asymmetric.

example, in the case that Portugal (or Greece) suffers a permanent fall in exports, output will contract and unemployment will rise as a currency depreciation is excluded and wages and prices are rarely flexible enough to react to economic slumps without causing unemployment (Dean 1997). The possible refusal of the ECB to implement an expansionary monetary policy in order to face recession in Portugal may cause continuing dissatisfaction among the Portuguese European citizens.

On the other hand, a decision by the ECB to implement monetary accommodation by increasing money supply, may cause continuing dissatisfaction among the anti-inflationary countries, such as Germany (Feldstein 1997). Economic disagreement over monetary policy would then cause general distrust among member-states and, as a consequence, would very possibly bring political disputes and instability. The ECB may thus face conflicting pressures that cannot be all satisfied (Frieden 1998).

Therefore, in case that the net real economic effect is negative, instead of increasing intra-European harmony, fostering stability and promoting integration, the establishment of the Euro would be more likely to lead to increased political conflicts within Europe, with unfortunate results.

1.2 Demand Disturbances and Trade

Optimist voices emphasize that the establishment of the Euro also favors, besides other benefits, a further increase in the volume of trade among EU member-states and in trade dependence (Emerson et al. 1992), enhancing welfare. The elimination of currency fluctuations within Europe will also mark, as believed, the end of a period of uncertainty which is considered to diminish trade itself and trade-promoting benefits (McKinnon 1994). In addition, since EU member-states enjoy a large volume of trade among them, it would be to their benefit to abolish national currencies, as the exchange rate policy tool becomes inefficient in attacking unexpected real asymmetric shocks.

On the other hand, standard theory suggests that free trade combined with fixed exchange rates prevent, to a large extent, governments from devising their domestic financial policy for the purpose of preserving domestic stability. With an exchange rate irrevocably fixed and the level of prices of domestically produced goods "sticky" to an unsupportable level, the loss of competitiveness will possibly end up in a fall of exports and, consequently, of trade volume. This way, overall trade both within EU and between the EU and other trade partners may decrease in the worst-case scenario. For the weakest Mediterranean EU countries in particular, there may be an increase of trade balance problems. In effect, external deficits for Greece and Portugal remain today as high (16 and 14 % of GDP respectively, 2000)[4] as they were in 1990, and in any case higher than they were right after the implementation of convergence policies (around 12-13% in 1992-93 for both countries) (Eurostat 2001). The deterioration of the external position of the aforementioned countries might be, at least partly,

[3] See for example GDP growth for 1999: Ireland 9.8%, Luxembourg 4.0%, Italy 1.4%, Germany 1.6% (Eurostat 2001).

[4] Similarly, Spain's external deficit worsened from -2.8% of GDP in 1993 to -6.2% in 2000.

attributed to a loss of competitiveness provoked in turn by a "hard currency" convergence strategy followed during the 1990s on the road to EMU.[5]

The inefficiency of EU mechanisms in facing the incidence and magnitude of demand disturbances under a single currency regime may impair production systems and so diminish trade, and thus welfare, particularly in lagging regions which otherwise may had withstood the shock. An individual member-state could not leave its currency free to fall in line with the fall of a foreign currency, such as the dollar, to maintain exports. If economic growth in such weak EU countries (or regions) keeps up with that external balance pressure, an overvalued Euro is not such a problem. But if it doesn't, as is the most possible scenario, an "expensive" Euro might cause a further loss of competitiveness, deepening the initial asymmetric shock.

Moreover, a country, which trades to a large extent with countries outside the EU, is likely to be affected by large fluctuations in the Euro-dollar exchange rate. Such countries are Greece (50% trade with non-EU countries), Ireland (64%), Finland (65%), while other countries such as Austria (37%), Benelux (39%) and Portugal (33%) are unlikely to be so affected.[6] The sharp differences that exist within the EU area are large enough for the one-size-fits-all monetary policy to be effective. Thus, the larger the differences, the greater the strains in managing the Dollar-Euro exchange rate and the greater the political disputes over the appropriate policy.

1.3 Responses to Labor Market Rigidities

Postponing the idea of a federal, truly unified Europe sterilizes the EU from the absolutely necessary –according to OCA theory—option of a strong redistribution of income among European regions and/or member-states through a high(er), in GDP percentage terms, European budget. Idiosyncratic shocks, low mobility of factors of production, stickiness of wages and prices, and overall relatively low economic performance in the so-called peripheral EU Southern countries –Greece and Portugal in particular—seriously obstruct the accommodation of shocks as relative prices and costs cannot adjust. Cohen et al. (1997) put the blame mainly on the high cost of firing workers in particular, while Abowd et al. (1997) emphasize the ill effect on jobs of a high minimum wage that negatively affects the growth rates and consequently the creation of net new jobs. Similarly, Blanchard and Wolfers (1999) and Blanchard (2000), point-out that labor market rigidities magnify the effects of shocks, although tight macroeconomic policies still remain the number one culprit for the high rate of unemployment in the EU.

As far as the European periphery in particular is concerned, the available data confirm the aforementioned stories. As Tables 1 and 2 show, the regulatory framework and employment protection legislation is fairly strict by international comparison in the EU and in the European periphery in particular, with the exception of Ireland. As a consequence, the economies can hardly absorb asymmetric shocks as labor market rigidities get on the way of any adjustment effort.

[5] In addition, Greece's exports to the EU countries decreased from 60.6% in 1995 to 43.6% in 2000, indicating a significant trade diversion. See Alpha Bank Economic Bulletin 2002, Greece.

[6] Source Eurostat, New Cronos, from Bjorksten and Syrjanen (1999).

Table 1. Strictness of Employment Protection Legislation (EPL) by International Comparisons: Qualitative indices

Countries	Regular & temporary contracts EPL#	
	1990	1998
USA	0.2	0.2
Japan	2.9	2.6
Germany	3.6	2.8
France	2.7	3.1
Italy	4.2	3.3
U.K.	0.5	0.5
Canada	0.6	0.6
Greece	3.6	3.5
Ireland	1.0	1.0
Portugal	4.2	3.7
Spain	3.7	3.2

#The index EPL ranges from 0 to 6 with higher values representing stricter regulations.
Source: Nicoletti, Scarpetta and Boyland [2001], from OECD (2001).

Table 2. Strictness of Employment Protection Legislation (EPL) by International Comparisons: Qualitative indices

Total tax wedge*	Employer's** social security contributions	Net replacement rate***
1996	1996	1997
FI 50.3	FI 20.5	FI 103
BE 48.2	BE 25.8	BE 72.0
GE 35.0	GE 16.8	GE 80.0
FR 45.4	FR 30.2	FR 84.0
IT 48.3	IT 31.7	IT 11.0
NL 39.9	NL 7.6	NL 82.0
AT 37.3	AT 19.6	AT 69.0
LU 22.7	LU 11.7	LU 91.0
IR 29.9	IR 10.7	IR 64.0
PT 30.9	PT 19.2	PT 77.0
SP 33.5	SP 23.5	SP 67.0

*% of gross labour costs for average production workers. Includes income taxes, employer and employee social security contributions; **% of gross labor costs for average production workers; ***% of the average earnings of a production worker in the 12th month of unemployment benefit receipt.
Source: OECD data from Bjorksten and Syrjanen (1999).

As Tables 1 and 2 show, labor flexibility in the EU is limited and differs from country to country. Given that labor flexibility is a prerequisite as a channel for adjustment in a monetary union - as the exchange rate instrument can no longer serve as an adjustment mechanism-, labor unions are expected to forcefully react against any liberalization measures.

As Alesina et al. (1997) rightfully emphasize, this could not alleviate but instead aggravate social tensions and increase political conflict both within and across countries.

As far as the antidote of labor migration (the shorthand for labor market flexibility) is concerned, labor flows of EU nationals remain quite low, around 0.1-0.2% of the destination countries' population (SOPEMI 1998; Krueger 2000). Indeed, net EU-national and non EU-national migration to EU has been sharply curtailed since the internal market was inaugurated. Sociocultural and language barriers certainly contribute to the low propensity of workers to migrate. Krueger (2000) presents evidence confirming that region-to-region migration is more than twice as high in the US as in many European countries and so EU unemployment can not be headed-off by emigration. The US absorbs asymmetric shocks by migration while the EU by a reduction in the labor force participation rate. It is evident that, in the European case, labor does not migrate if one member-state or region flounders. With rigid labor markets, cyclical unemployment turns into structural.

A generous increase of the EU budget could partly offset labor market rigidities. The EU budget represents only 1.27% of the EU combined GDP, a much lower share than that which the Commission itself has proposed in the past (5-7% of GDP) to moderate idiosyncratic business cycles. In the US, the federal budget is four times higher than even those past EU proposals. Through transferring tax revenues to disadvantaged regions (i.e. federal states) the government subsidizes them through automatic fiscal stabilizers that function as an effective insurer against economic shocks (Sala-i-Martin and Sachs 1991; Bayoumi and Masson 1995). The federal government absorbs between 30 and 50% of each dollar of an asymmetric regional disturbance by reducing tax receipts and by transferring extra money to the shock-stricken regions. That is a government policy with high redistribution and stabilization effects.

In the EU, the corresponding effects are almost negligible, providing only one half a cent reduction per dollar in taxes in the event of an economic shock. As wage flexibility is low, price adjustments very slow, and migration limited, demand disturbances are expected to have a severe adverse economic impact on any shock-stricken EU region unless a generous "Brussels budget" did the job of compensating those regions.[7]

Under Maastricht and Amsterdam fiscal restraints, the EU member-states could not have the possibility of using domestic stabilization mechanisms, namely the national fiscal stabilizer. A "generous" EU budget or the establishment of a proper central fiscal policymaking authority (Bordo and Jonung 1999; Pelagidis 1998; Crowley 2001: 393ff), both as to now excluded from the integration project, could have alleviated unemployment and regional inequalities, by redistributing fiscal resources to the floundered member-states and/or regions. This could be done as an automatic consequence of a progressive inter-regional tax and social security system. The redistribution acts as a stabilizer with negative shocks, leading to lower taxation and higher security payments in the region that is adversely affected

[7] Obstfeld (1997) argues that a fiscal system favoring regional cohesion interacts with a rigid labor market to discourage mobility. However, as argued in this paper, national fiscal policies across member-states are too contractionary to cushion the country or regional downs. In addition, Community Framework Programs are too limited to have significant stabilization effects. Therefore, despite the lack of fiscal automatic stabilizers, flexibility of wages and mobility of labor remain at very low levels. As a consequence, it can not be sustained that there exists a trade-off between labor mobility/flexibility and fiscal stabilization policies.

(Arestis et al. 2001). Without such kind of policy measures, economic prosperity and political stability across Europe might be called into question.

1.4 Shortage of Money Stocks for the Peripheral Countries

Lets assume that member-state A experiences a positive demand shock while member-state B experiences a negative one. Country B's trade balance will deteriorate and present a deficit while country A's will present a surplus. Lets assume that country B is Portugal or Greece and country A is Germany. In this case, Portugal's Euromoney stock will decline as it finances its deficit in the trade balance. As a result, money stock in country A (Germany) increases and its interest rate declines while money stock in Portugal decreases and its interest rate increases. The symmetric adjustment that takes place is unfavorable for Portugal as it is forced to reduce money supply and accept a permanent recession. The symmetric system could evolve into an asymmetric one, as Germany may absorb the extra inflows by selling government bonds in the money market to avoid an unexpected surge of inflation. It is worth mentioning that Portugal needs higher growth rates in order to approach the average EU living standards. Assuming that peripheral countries are more vulnerable to shocks due to low productivity levels, a predominance of traditional sectors, less skilled human capital, and so on, and taking into account that Community money will dry up in the near future, the single currency may bring economic insecurity for the weak and vulnerable member-states such as Portugal or Greece.

Asymmetry is further enhanced by the variation of monetary transmission mechanisms across the Eurozone. Countries with a higher reliance on short-term bank credit (the Southern European group) would be affected more strongly and rapidly by interest-rate changes compared to economies that rely more heavily on longer-term finance (such as Germany, Belgium, Austria and the Netherlands) (Ramaswamy and Sloek 1997).

Summing up, in the presence of nationally asymmetric real shocks, cultural stresses and possible political disputes over policy priorities, the EU has to elaborate specific, differentiated and flexible responses both at European and national level. Taking into account EU enlargement and given that most Eastern European countries are far behind both in productivity levels and in standards of living, asymmetric shocks are clearly on the cards.[8] A "broad" Union will be even more vulnerable to demand disturbances and, so, disputes regarding the economic policy mix are expected to appear. Henceforth, the question that arises concerns the appropriate strategy for riding out real peripheral shocks.[9] The following section attempts to elaborate some of the features of such strategy.

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[8] The differences in productivity among the EU member-states are quite sharp (EU=1.00, Belgium 1.2, France 1.20, Denmark 1.18, Germany 1.15 and Greece 0.56, Portugal 0.43). The prospect of enlargement will widen the gap between the "developed north" and the "poor south and east", further dramatizing the economic and political effects (European Commission [1999] from Boldrin and Canova [2000]).

[9] Alesina, Spolaore and Wacziarg (1997) argue that as trade globalization deepens, the original motivation of a large country to join a Currency Union becomes less important. Large countries normally enjoy the advantages of "being big", including economies of scale. Under trade globalization they argue that one country has no more any incentive to proceed to political integration as it can trade and become economically integrated with the rest of the world. In this context, they observe that economic integration goes hand-in-hand with political separatism and not with political integration, as is in the case of the EU.

2. Asymmetric Responses and the New "Stabilization State"

To a considerable extent, EMU provides some corrective mechanisms for offsetting the asymmetries inherent in its structure. To begin with, integration and harmonization is an ongoing dynamic process, which, as it advances, creates conditions that offer some cushioning from asymmetric shocks. This concerns both present and future EMU member states (enlargement countries that manage to satisfy the Maastricht criteria while having incorporated the EU institutional *acquis*). The common currency in itself, combined with market liberalization, promotes economic harmonization, while, according to the orthodox view (against which, however, the earlier-mentioned critique has been raised), more trade integration enhances convergence in production structures. Financial portfolio diversification in the Eurozone allows for better risk-sharing which offers some cushioning against asymmetric shocks (Asdrubali et al. 1996; De Grauwe 2000). Real convergence as regards the EU periphery has been and continues to be promoted by EU structural funds, whose future however after 2006 remains unclear. More broadly, the strengthening of a unifying European cultural identity at least across certain socioeconomic strata erodes some of the cultural barriers that get on the way of further labor mobility. All these factors promote convergence and harmonization, but their importance should not be exaggerated, and their ability to offset the problems of asymmetry described above remains limited.

For one thing, some factors of asymmetry should be sustained. For instance, wage-setting cannot be harmonized across the Eurozone but should remain in accordance with productivity levels. Given the differential productivity levels in various EU peripheries, labor institutions should be flexible enough to allow wage-setting to adapt to the fluctuations of productivity. Otherwise, labor institutions that are centrally designed, uniform and rigid may lead to inflationary wage increases, which may damage the competitiveness of the periphery. Moreover, a broader argument of institutional embeddedness can be made on behalf of national-, regional- and sectoral-level institutional and structural asymmetry. Institutions are notoriously resistant to change, not least because they are embedded into broader social systems of production, "nested" at global and regional level, interdependent with other institutions (Boyer and Hollingsworth 1997; Hall and Soskice 2001). Status quo interest coalitions flock around them, tending to reproduce a status quo legitimizing discourse, further reinforced by the recognition of the sunk costs invested in the existing institutional order. Some institutions amount to a comparative advantage by their interaction and embeddedness in the surrounding institutional order. It is through such embeddedness that efficiency is derived. Thus, transplanting specific institutions that may be successful in one national institutional context to another may not guarantee the same success. Institutions must be embedded in a compatible institutional context to provide the basis for comparative advantage. This is an argument for asymmetry not being just inevitable but, in fact, desirable too.

2.1 The Fiscal Strategy against Asymmetric Socioeconomic Disturbances

It follows from the analysis expounded in the first section that two principal economic strategies are available for combating the weaknesses and conflicts arising from the Eurozone not being an OCA. One is a fiscal policy strategy, whose importance arises especially at times

when a countercyclical expansion would be needed at national or regional level, but which is also vital in order to raise the levels of investment spending. Ultimately, as said, the sustained way to deal with asymmetry is to move towards fiscal federalism, establishing a proper Eurozone fiscal policy and automatic inter-regional transfers. The issue of a "deeper" Union has reverberated in the Convention ("Debate on the Future of Europe") and is bound to continue to do so in view of the 2004 Intergovernmental Conference, also given EU enlargement. An EU fiscal policy, of course, would presuppose federal political institutions to provide democratic legitimization for levying taxes on European citizens (McKay 2002: 80-1). Strong sociopolitical resistances in EU member states and fear of Eurosceptic or nationalistic backlash get on the way of a bolder promotion of the federalist agenda.

The second version of the fiscal strategy and an immediately accessible avenue towards confronting the possibility of asymmetric shocks is through national-level fiscal flexibility greater than the one allowed under the 3% budget-deficit limit posed by the –increasingly vilified—Stability and Growth Pact (SGP). As it stands, EMU discourages the countercyclical use of fiscal policy.[10] There is an inbred fear in the EMU architecture that relaxing SGP to allow for more national-level fiscal flexibility may create future tax liability and lead to unsustainable public debt dynamics. Even if EMU member states were to defy SGP rules or the intergovernmental commitment to balanced budgets or primary surpluses, the Pact's disciplinary role would be taken over, to a considerable extent, by public debt markets (raising risk premia on new debt), by the Maastricht Treaty no-bail-out clause (prohibiting EU governments from helping each other), and potentially by financial regulators as well (prohibiting large exposures of banks to government bond holdings) (Buti et al. 1997; Lemmen 1999; Eijffinger and de Haan 2000; Buti et al. 2003). Thus, fiscal discipline in the EMU is the direct consequence of liberalized and globalized financial markets penalizing and thus discouraging any medium- to long-term divergence from fiscal discipline.[11] That said, the 3% budget limit, while serving the ambition of vesting the Euro with increased credibility, may in fact be more flexible than it appears, since it requires balanced budget or surplus in the medium term. This target has been interpreted as the structural deficit, which will allow automatic stabilizers to work in a recession. Thus, if all Eurozone countries had reached the medium-term target, they could stabilize their economy by using fiscal policy while respecting SGP in a normal recession (Artis and Buti 2000). (If the recession is more severe, the SGP penalty does not apply anyway). However, most member-states have not reached such fiscal consolidation yet.

2.2 The Structural Strategy against Asymmetry and the New "Stabilization State"

A second economic strategy, apart from the fiscal one, is available for combating the weaknesses and conflicts arising from the Eurozone not being an OCA. This strategy (having

[10] Eichengreen and Wyplosz (1998: 106) estimate that if the Stability Pact had been in force over the period 1974-95, the cumulated output losses for France, Italy and the UK would range between 5-9% of GDP –an estimate disputed by Bean (ibid) who holds that the output losses are at least half as much as Eichengreen and Wyplosz suggest.

[11] Article 3a of the Treaty on European Union specifies the guiding principles of economic policy as "stable prices, sound public finances and monetary conditions, and a sustainable balance of payments".

conceded that the roots of unemployment are mostly structural) is structural reform in the labor markets to the direction of greater flexibility. While the first "fiscal strategy" operates at EU and intergovernmental level (even a SGP loosening requires collective EU decision-making) the second relies almost exclusively on national-level institutions and policymaking. Thus the second pillar of the adjustment strategy consists of asymmetric national responses, corresponding to different sociopolitical and institutional endowments of Eurozone member states.

Both national-level fiscal strategy and structural strategy fall within the realm of subsidiarity requiring policy action at state level. Together they shape the economic role of the state under EMU. We will try to outline here the main features of the new "stabilization state" (Dyson 2000; Pagoulatos 2000, 2003) that emerges in the EMU framework, to be juxtaposed to the "developmental state" or the "interventionist state" of the past. The stabilization state is devoid of interventionist instruments such as incomes policies or price and credit controls extensively relied upon by European governments in the past, and which under the new liberalized environment are increasingly rendered obsolete or ineffective. A hands-off market regulator, the stabilization state will seek to rely on market allocation and to diminish state interventions under the premise that interventions would create longer-run disequilibria by distorting market signals and resource allocation. In the 1990s' EMU transition period, the stabilization state entered a self-binding process of subscribing to extra-national institutions such as the EMU convergence criteria or surveillance mechanisms, that is external mechanisms inducing politically painful adjustment by altering the government's incentive structure. The stabilization state is committed (and institutionally circumscribed) to macroeconomic discipline and fiscal self-restraint. This is aimed to prevent the Eurozone from sliding into a beggar-thy-neighbor macroeconomic spiral, and to allow ECB to deliver price stability and the Euro to acquire the necessary credibility. Founded as it is on the institutional pillars of an independent ECB, fiscal restrictions on member states, and the lack of an EU fiscal authority, the EMU architecture is well equipped to deal with the problem of inflation but far less so with that of faltering growth and unemployment. EMU is much better suited to confront a "debt trap" than a "liquidity trap".

It is especially in the European periphery that the state may require more flexibility than the one enshrined in the EMU text. That is not only because the periphery remains relatively more vulnerable to asymmetric shocks but also because Southern European countries (Spain, Greece and Portugal), let alone the new enlargement economies of Eastern Europe, had been used to a more interventionist or developmental state. Postwar developmental states intervened (usually but not necessarily through an operationally autonomous state bureaucracy) to identify and choose the sectors and industries to be developed, and to formulate the best means of an industrial rationalization policy. Such means involved the creation of public financial institutions and far-reaching financial interventionism, indicative planning, an extensive reliance on public corporations, an unconsolidated investment budget separate from and not funded by the general account budget, government-supported R&D, and so on (Woo-Cumings 1999). Many such developmental institutions and policies were established postwar, when Spain, Portugal and Greece were still developing economies, and were retained through much of the postauthoritarian period as well, fossilized under the inertia of the status quo, often degenerating into instruments of electorally-minded interventionism (cf. Maravall 1993 and 1997). Though EU accession and market liberalization over the 1980s and 1990s eradicated most of the remaining interventionist

institutions and policies, South European markets continue to lag in efficiency and their ability to operate in a self-regulating manner.

2.3 State Flexibility and Asymmetric Responses to Confront EMU Asymmetry

As already mentioned, the second major strategy for confronting the possibility of conflicts arising from the EMU inability to effectively redress asymmetric shocks is a structural strategy. That points to a state role of greater flexibility and perhaps assertiveness than one would tend to assume given the constraining conditions of EMU. Indeed, the primacy of macroeconomic discipline is not incompatible with the pursuit of microeconomic policy objectives. An environment of sustained monetary stability may indeed provide a setting conducive for state developmental functions, exercised however in a more indirect manner. The stabilization state is still assigned with delivering fundamental public goods, beginning with creating and safeguarding regulatory conditions that allow markets to operate efficiently. That said, the expansion and integration of markets does not negate but indeed revives concern over market failures, intensifying the need for higher regulatory vigilance. Moreover, principal among the state's developmental tasks remain public investment in infrastructure, education and training, new technologies and R&D, where private initiative often lacks adequate incentives or capacity to mobilize. On the supply-side, the state's role remains important in flexibly resolving market failures and facilitating provision of public goods through synergies with the social partners. For instance, investment in new technologies and especially employee retraining may be far less efficient if attempted without coordination with labor and business; business may be incapable of resolving its own collective action problems in these fields without state mediation. In such or similar cases the state assumes the flexible, indirect developmental role of an honest broker, a mediator of social pacts, aimed to expedite economically necessary and politically sustainable structural and sectoral adjustments. In such ways, the stabilization state is no more a direct provider of growth, but rather a partner and facilitator (World Bank 1997).

This new, indirect, developmental role of the stabilization state and the revival of social pacts in a general framework of macroeconomic discipline *is* compatible with increased capital mobility, contrary to what is typically argued. Indeed, the standard argument holds that globalization, with the increased mobility of capital it involves, erodes the role of the state and disintegrates the institutions of neocorporatism, as the government's growing inability to manage demand undermines both the government's need for union cooperation and the unions' incentives to organize collectively (Streeck and Schmitter 1991; Kurzer 1993; Rodrik 1997: 14ff; Simmons 1999). However, there are good reasons why the above conclusion should be tempered. First, the mobility of real investment capital remains relatively limited, also given the significant transactions costs of relocating; investment flows and national savings continue to remain highly correlated (Obstfeld 1998). Established industrial enterprises at least in continental Europe continue to have an interest in collective agreements that allow wage moderation and industrial peace. They have an interest in politically sustainable agreements that will be viable on the long run (for example pension reform) and will not lead to political instability or become uprooted by the next government. This means that employers may actually prefer to settle for second best solutions, this second-

best preference resulting from the fear that economic solutions they may regard as optimal (wide-ranging structural liberalization) may create a political backlash which could lead to a total reversal of the reforms. Thus employers have an interest in seeking consensus, especially given their increased bargaining power resulting from the discourse and reality of globalization, which ensures that they will manage to defend their interests to a high extent. Labor unions too want social pacts with government intermediation. Their preference results from understanding their relatively weaker bargaining power and that social pacts is the only way of defending crucial social *acquis* from a complete surrender to neoliberal deregulation. As the fiscal constraint fell heavy upon welfare state entitlements, labor unions in many EU countries sought to defend social insurance and labor legislation in return for accepting more flexibility and the expansion of part-time employment. Finally governments, especially (but not exclusively) socialdemocratic ones, seek social pacts to respond to the concerns of both labor and capital, and to strike a balance between economic constraints and the democratic electoral imperative (cf. Kitschelt 1999). They thus seek to vest with the highest possible sociopolitical consensus what is usually an agenda of unpopular economic reforms (imposed by the EU, international markets, or severe domestic economic imbalances). Consequently, social pacts were extensively relied upon in several EU countries during the 1990s (Fajertag and Pochet 2000; Regini 2000; Crouch 2000).

Social pacts revive faith in neocorporatist bargaining, facilitating structural reforms but also smoothening domestic adjustment to cyclical disturbances. Clearly, such responses remain asymmetric given not only the asymmetry of the respective shocks but also that of the existing institutional endowments. What Soskice (1990, 1999) has defined as coordinated market economies (relying on long-term industrial financing, systematic organization of labor and business, coordinated wage bargaining, serious vocational training with the involvement of business, intercompany systems enabling technology and standard-setting cooperation) are far more prone and keen to respond with neocorporatist strategies and social pacts than are Anglo-Saxon type uncoordinated or liberal market economies. While the former seek competitiveness through a highly skilled labor force, in the latter the lack of dependable organizational structures of longer-term collective action privileges the pursuit of labor market deregulation and strong individualist competition at the expense of positive-sum cooperation in the business sector. Southern European economies, carrying considerable features of coordinated market economies but not fully belonging to this category (mostly due to a heavy tradition of postwar state corporatism) can be expected to develop systematic features of the neocorporatist strategy, as they already have (cf. Schmitter 1995; Pagoulatos 2003). This is even more so as the bigger the structural reforms EU economies need to undergo, the higher the sociopolitical consensus required to enforce them.

Such asymmetric responses and state flexibility become necessary also along the lines of a political rationale. Under the Eurozone architecture, the institutional–systemic inability to handle asymmetric shocks means that socioeconomic instability has a bearing on the political underpinnings of the EMU regime (especially given the underdevelopment of institutions of political integration to absorb socioeconomic conflict). Thus, under the Eurozone, socioeconomic unrest is more easily translated into political instability, growing Euroscepticism, and antisystemic movements –as the recent re-emergence of the extreme Right in Europe demonstrates. This is even more so since the EU reality nurtures highly heterogeneous Eurosceptic coalitions, comprising from disgruntled farmers to bourgeois nationalists to non-competitive small-scale businesses to crime-vulnerable low-income

elderly citizens to the unemployed. Antisystemic tendencies of the population are dealt with more effectively within a national political framework in which governments are able to activate flexibly the economic and other policies that respond to popular angst and specific concerns. Compared to EU- and Eurozone-level politics and policymaking, national politics is more capable of fine-tuning the policies that reflect public sentiment, thus preventing extreme sociopolitical dissent and the threat of a systemic breakdown. This strengthens the argument for increased state economic flexibility and asymmetric responses (politically as well as institutionally) to the asymmetric socioeconomic shocks produced under EMU.

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