Shocks, unemployment and adjustment – the limits of the European union

By Christophe Blot

In an article published in 2013 in *Open Economies Review* [1], C. A. E. Goodhart and D. J. Lee compare the mechanisms for recovering from the crisis in the United States and Europe. Based on a comparison of the situation of three states (Arizona, Spain and Latvia) faced with a property crash and recession, the authors explore the reasons for the growing divergence observed among the euro zone countries, a divergence that is not found in the United States. Their analysis is based on the criteria for optimum currency areas, which enable the members of a monetary union to adjust to adverse shocks and to avoid a lasting difference in their unemployment rates during an economic slowdown or downturn. While Latvia is not formally part of a monetary union [2], its currency nevertheless has remained firmly anchored to the euro during the crisis. Thus none of the countries studied by Goodhart and Lee resorted to a nominal devaluation to absorb the financial and real shocks that they faced. The authors conclude that while Arizona dealt with the shocks better than Spain, this was due both to the greater fiscal solidarity that exists between the states of the United States and to the greater integration of the US banking system, which helps to absorb shocks specific to each state.

In addition to *de jure* or *de facto* membership in a monetary union, Arizona, Spain and Latvia also all went through a real estate boom in the 2000s, followed by a correction that began in 2006 in Arizona and Latvia, and a year later in Spain (Figure 1). The real estate crisis was accompanied by a recession, with the same time lag persisting between Spain and

the other two states. Latvia recorded the sharpest downturn in activity (-21% between 2007 and 2010). However, the downturns experienced by Arizona (-5.5% since 2007) and Spain (5% since 2008) were comparable. While the downward adjustment of the property market stopped in Arizona (recovery is underway in the US state), the recession is continuing in Spain. Overall, this difference in adjustment is reflected in a continuing increase in unemployment in Spain, whereas it has fallen by 2.8 percentage points in Arizona from the peak in the first quarter of 2010 (Figure 2).

Spain's inability to pull out of the recession along with the increasing divergence of the economies in the euro zone raises the question of the capacity of the euro zone countries to adjust to a negative shock. The theory of optimum currency areas, originally developed by Mundell in 1961 [3], can help to evaluate the conditions in which a country may have an interest in joining a monetary union. The optimality of this choice depends on the country's ability to absorb shocks without resorting to currency devaluation. Different adjustment mechanisms are involved. These consist mainly of the following: [4] the flexibility of prices and in particular of wages; labour mobility; the existence of fiscal transfers between the countries in the monetary union; and financial integration. Price flexibility corresponds to an internal devaluation mechanism. As for depreciation, the point is to become more competitive – by lowering relative labour costs – to stimulate exports and growth during a negative shock. However, this type of adjustment generally takes much longer and is more costly, as is suggested by the recent examples of Iceland and Ireland.[5] Labour mobility makes for an adjustment whenever the recession leads people to migrate from a state with high unemployment to one where it is lower. The implementation of fiscal transfers occurs when various mechanisms in states where growth is slowing make it possible to benefit from stabilizing transfers from other states in the union or from a higher level of government. Finally, Goodhart

and Lee also consider the stabilizing role of the local banking system. In this case, in the euro zone, the less the local banking system has been weakened by the real estate crisis or the public debt crisis, the greater is its capacity to absorb the shock.

The authors analyzed the adjustment of the economies in question in the light of these four criteria. They studied in particular the degree of price flexibility and labour mobility as a function of unemployment in the three states. Then they evaluated the importance of fiscal transfers and the architecture of the banking landscape. Their findings were as follows:

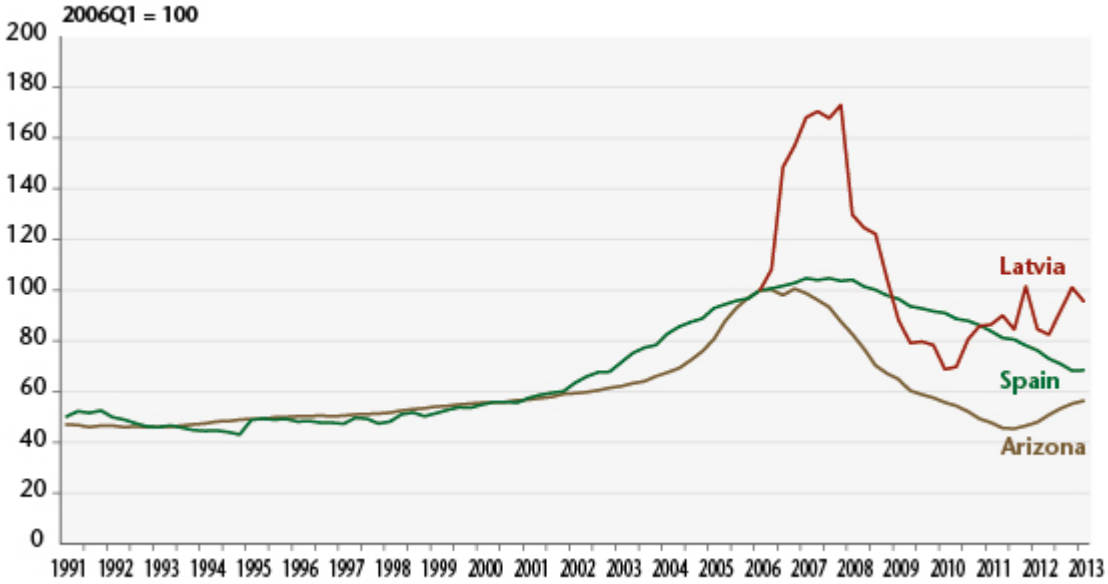
1. Price flexibility has played only a marginal role in adjustment, except in Latvia where rising unemployment has led to a decline in unit labor costs. These costs did not on the other hand react significantly to the rise in unemployment in Spain and Arizona.
2. Though migration is more marked in the United States than in Europe, the differences are still not able to explain the gap in the adjustment of unemployment rates. However, it appears that the role of migration as an adjustment mechanism has strengthened in Europe. Nevertheless, this is still insufficient to ensure the convergence of unemployment rates.
3. In 2009 and 2010, Arizona received substantial transfers from the federal government, whereas at the European level there is no automatic mechanism for transfers between states. Even so, Latvia received assistance from the IMF in 2009, while the euro zone countries came to the aid of Spain’s banks. Nevertheless, in the absence of a more substantial EU budget, the European countries can benefit only from emergency assistance, which, while able to meet a specific need for funds, is not sufficient to play the role of an economic stabilizer.
4. Finally, the authors emphasize that the financial

> amplification of the shocks was on a lesser scale in Arizona in so far as the bulk of the banking business is conducted by national banks that are consequently less sensitive to local macroeconomic and financial conditions. The risk of credit rationing is thus lessened, which helps to better absorb the initial shock. In Spain, with the exception of a few banks with international operations, which enables them to diversify their risks, banking depends on local banks, which are therefore more vulnerable. This increased fragility pushes the banks to restrict access to credit, which reinforces the initial shock. Latvia is in an alternative position in that its financial activity is carried out mainly by foreign banks. The nature of risk thus differs, because local financial activity is disconnected from Latvia's macroeconomic situation and depends instead on the situation in the country where these banks conduct their principal activity (*i.e.* Sweden, to a great extent).

The crisis in the euro zone thus has an institutional dimension. From the moment the countries freely consented to surrender their monetary sovereignty, they in effect also abandoned the use of a currency devaluation to cushion recessions. However, it is essential that alternative adjustment mechanisms are operative in order to ensure the "sustainability" of monetary unification. In this respect, the article written by Goodhart and Lee is a reminder that such mechanisms are still lacking in the euro zone. Negotiations over the EU budget have not offered any prospect for the implementation of fiscal transfers to stabilize shocks at the European level. The discussion on Eurobonds has stalled. Although the European Stability Mechanism (ESM) acts as a tool for solidarity between Member States, it meets a different need, because it involves only emergency financial assistance and is not a mechanism for automatic stabilization. Banking integration could also help dampen fluctuations. However, the

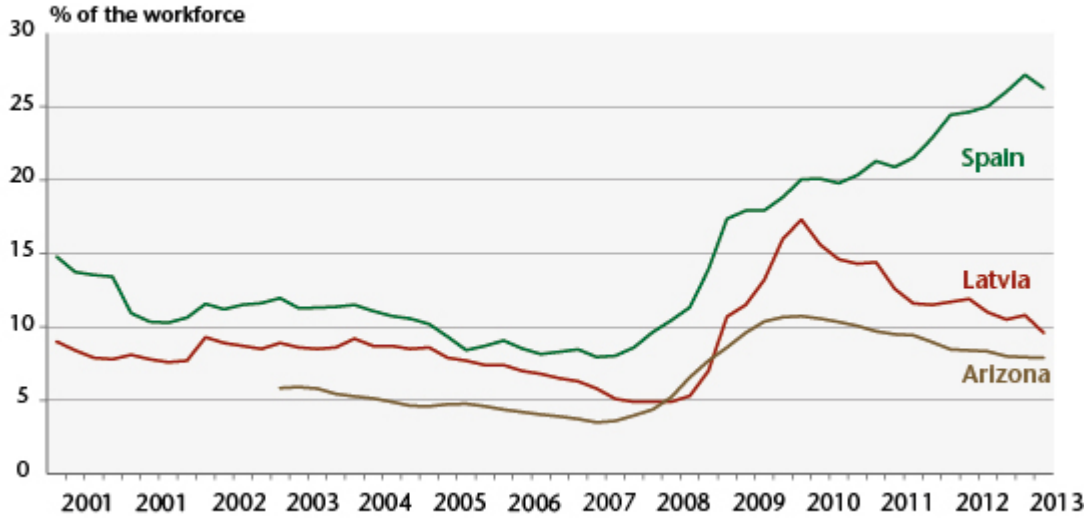
crisis has led to greater fragmentation of European banking markets. The latest report on financial integration in Europe, published by the ECB, shows a 30% decrease in cross-border bank flows in the recent period. Similarly, despite the common monetary policy, the interest rates charged by European banks have recently diverged [6] (Figure 3). Thus, despite the European banking passport created by the European Directive of 15 December 1989 on the mutual recognition of authorizations of credit institutions, cross-border banking in Europe is still relatively undeveloped. The retail banking model is based on the existence of long-term relationships between the bank and its clients, which undoubtedly explains why the integration process is taking much longer than for the stocks, bonds and currency markets. It is nevertheless still the case that a banking union could be a further step in this difficult process of integration. This would promote the development of transnational activity, which would also help to de-link the problem of bank solvency and liquidity from the problem of financing the public debt.

Figure 1 : Changes in real estate prices in real terms



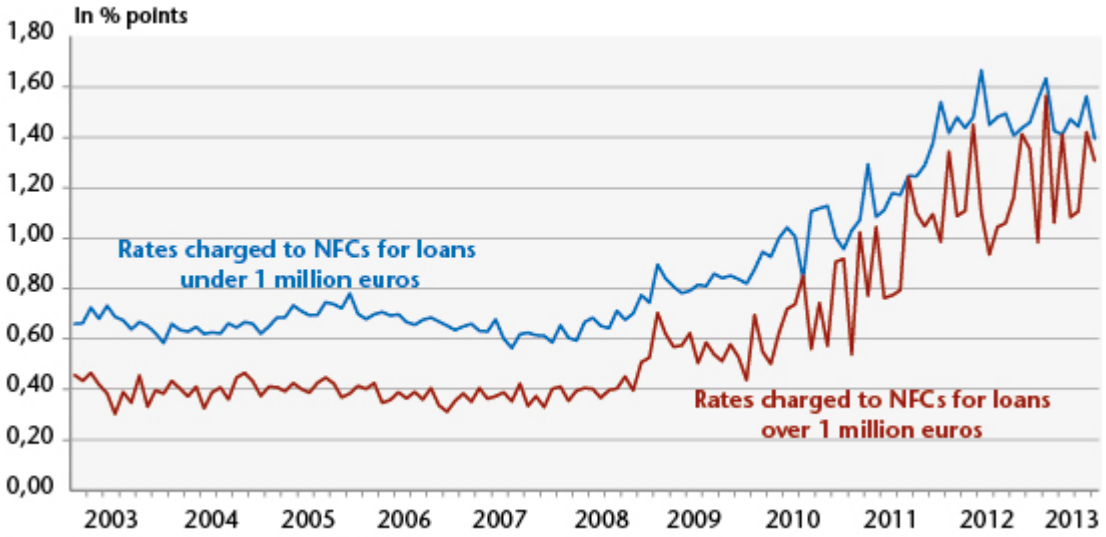
Source : Bank of International Settlements, Federal Housing Finance Agency.

Figure 2 : Unemployment rates



Sources : Bureau of Labor Statistics, Instituto Nacional de Estadisticas, Agence nationale pour l'emploi (Latvia).

Figure 3 : Dispersion of rates charged by banks in the euro zone



Source : European Central Bank. NFC = Non-financial corporation.

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[1] "Adjustment mechanisms in a currency area", *Open Economies Review*, January 2013. A preliminary version of this article can be downloaded at: http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP212.pdf

[2] Latvia has been part of the European currency mechanism since 2005 and is to adopt the euro on 1 January 2014.

[3] "A theory of optimum currency areas", *American Economic Review,* vol. 51, 1961.

[4] One could also add the level of an economy's openness or the degree of diversification of production. Mongelli (2002) offers a detailed review of these various criteria. See: "New views on the optimum currency area theory: what is EMU telling us?", *ECB Working Paper,* no. 138.

[5] See Blot and Antonin (2013) for a comparative analysis of the cases of Ireland and Iceland.

[6] C. Blot and F. Labondance (2013) offer an analysis of the transmission of currency policy to the rates charged by the banks to non-financial companies (see here) and to real estate loans (see here).

The death throes of the "Confederation of Europe"?

By Jacques Le Cacheux

Will the institutions that the European Union has developed – from the Treaty of Maastricht in 1992, which created it and defined the roadmap that led to the launch of the euro in 1999, to the Treaty of Lisbon in 2009, which took up the main articles of the constitutional treaty that the French and Dutch had refused to ratify in referendums in 2005 – be sufficient to resolve the crisis facing the EU today? After five years of economic stagnation and nearly four years of persistent pressure on national debts, it had seemed that fears about the sustainability of the European Monetary Union had been appeased by the determination shown in early autumn

2012 by Mario Draghi, President of the European Central Bank, to ensure the future of Europe's single currency at any cost. But the results of the recent general elections in Italy have once again unsettled the European sovereign debt markets and revived speculation, while the euro zone has plunged back into a recession even as the wounds of the previous one lay still unhealed.

How much longer will we be content with mere expedients? Would it not be better to make a real institutional revolution, like the one undertaken between 1788 and 1790 by the framers of the Constitution of the United States of America, as they faced an acute crisis in the public debt of the Confederation and the confederated states? In his Nobel Lecture, which the OFCE has just published in French, Thomas Sargent invites us to consider this through an economic and financial reading of this critical episode in the institutional history of the United States, and through a parallel with the current situation of the euro zone that some may find audacious, but which is certainly enlightening.

There are of course many differences between the situation of the former British colonies ten years after independence and the Member States of the European Monetary Union. But how is it possible not to see certain similarities, such as the inability to find a collective solution to the national public debt crises or the inanity of the agreement in February 2012 on the future EU budget? *Mutatis mutandis*, it is a question of fiscal federalism, as well as political, in one case as in the other.

Obama 2012: “Yes, we care!”

By Frédéric Gannon (Université du Havre) and Vincent Touzé

On Thursday, 28 June 2012, the United States Supreme Court delivered its verdict. The principle that individuals are obliged to take out health insurance or else face a financial penalty, a central plank in the 2010 reform [1] of the health insurance system (the Affordable Care Act [2]), was held to be constitutional. This reform had been adopted in a difficult political context. It includes a variety of measures intended to significantly reduce the number of Americans without health coverage. Although it will increase federal spending, new revenues and spending cuts will make it possible to reduce the deficit.

From September 2009 to March 2010, there was a lengthy process of drafting and approving the law, with an uncertain outcome due to the lack of a majority in the Senate [3]. Since the law passed by the House of Representatives and signed on 23 March 2010 by President Obama differed from the version passed by the Senate, amendments were introduced in a Reconciliation Act that was passed on March 30th. Opponents of the reform (26 states, numerous citizens and the National Federation of Independent Business) then decided to take the fight to the US Supreme Court. Their hopes rested mainly on the possible unconstitutionality of the law, which centered on the individual’s obligation to take out health insurance, called the “individual mandate”, and on the expansion of the Medicaid public insurance program.

The favourable judgment of the Supreme Court was obtained with a narrow majority: five judges voted for [4] and four against [5]. The political inclinations of the judges did not seem to have worked against the law, since Chief Justice John G. Roberts, an appointee of George W. Bush, gave his approval. The Supreme Court majority considered that the financial

penalty for a failure to take out insurance is a tax [6] and that it had no cause to rule on the merits of such a tax. It passed this responsibility to Congress (the upper and lower houses) which, in this case, has already debated and approved the law. Consequently, this point of law is valid.

According to the Supreme Court, the financial penalty for failing to purchase health insurance could be viewed as an individual obligation to purchase [7], and "the Commerce Clause does not give Congress that power". But from a functional standpoint, this penalty can be regarded as a tax, in which case Congress has discretion to "lay and collect Taxes" (Taxing Clause). Hence the positive verdict of the Supreme Court. However, the Court believes that "the Medicaid expansion violates the Constitution" because the "threatened loss of over 10 percent of a State's overall budget is economic dragooning that leaves the States with no real option but to acquiesce in the Medicaid expansion".

The Supreme Court decision represents a major victory for President Barack Obama, who had made a reform to ensure more equal access to the health insurance system one of the spearheads of his 2008 election campaign. His Democratic predecessor in the White House, Bill Clinton, previously had to abandon a similar reform due to fierce opposition from the Republicans and growing divisions among the Democrats. In order to give himself every chance of success, Obama has had to be more strategic in the programming of both the reform and the way it was presented [8]. To do this, he also assembled a team of experienced specialists [9].

The Act represents a real cultural revolution in a country where the health insurance system excludes nearly 50 million people. Besides the individual mandate requiring Americans to purchase health insurance, the ACA's main measures are:

- The creation of "exchanges" for insurance contracts where people can buy health coverage, with a government

subsidy that depends on the level of income;

- Expansion of the Medicaid public health insurance program [10] (public coverage for all households with incomes below 133% of the federal poverty level) and financial penalties on states that choose not to implement this expansion (elimination of all federal funding of the Medicaid program);
- A requirement that employers offer health insurance to their employees (application of financial penalties if the obligation is not met, with exceptions for small businesses);
- New regulations on the private insurance market (obligation to offer coverage to all individuals, with no conditions on their health status).

Beginning in 2014, millions of uninsured American households should benefit from the expansion of Medicaid, which the Supreme Court has now ruled unconstitutional – this raises numerous questions [11]. How many States will be tempted not to expand Medicaid? What are the consequences for the poor households [12] who were to benefit from this expansion? Will they have the means to afford subsidized private insurance [13]? Will they be penalized financially if they do not buy insurance? Will they be encouraged to migrate to States that have adopted the expansion [14]? It is reasonable to expect that few States [15] will boycott the expansion of Medicaid, as the ACA offers them other strong incentives (federal assumption of 100% of the additional cost from 2014 to 2016, then 95% after 2017, and 90% after 2020; loss of some federal funds if no expansion). However, adjustments in the law will likely be useful if policymakers want to avoid excluding those who are too poor to afford subsidized private insurance.

The law will come into force gradually, with the various measures to apply from 2014. According to the latest report by the Congressional Budget Office (2012), annual government expenditure (expansion of Medicaid and private insurance

subsidies) should rise by about $265 billion per year [16] by 2022 (the estimated total cost between 2012 and 2022 is $1,762 billion), and the number of uninsured should fall by about 33 million [17]. The reform also provides for an increase in tax revenue (higher compulsory levies and new taxes) and a reduction in federal spending (primarily substitutions between the expanded Medicaid program and the old program). This will result in amply offsetting the cost of the reform. In a previous report in March 2011, the CBO estimated that the total reduction in the deficit over the period 2012-2021 will come to $210 billion. In the name of hallowed liberties, however, there is still strong opposition to the individual mandate [18], but over time it can be hoped that this mandatory principle will come to be viewed first and foremost as a basic right that protects all citizens.

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[1] For an overview of the health insurance system and the reform, see Christine Rifflart and Vincent Touzé, "La réforme du système d'assurance santé américain", *Lettre de l'OFCE, n°321*, 21 June 2010. Also see the Wikipedia article on this subject.

[2] This legislation reconciles the two laws, the *Patient Protection and Affordable Care Act* and the *Health Care and Education Reconciliation Act*.

[3] "Health Care Reform: Recent Developments", *The New York Times, June 29*, 2012.

[4] Stephen Breyer, Elena Kagan, Ruth Bader Ginsburg, and Sonia Sotomayor, along with Chief Judge John G. Roberts.

[5] Clarence Thomas, Anthony Kennedy, Antonin Scalia and Samuel Alito.

[6] Floyd Norris, "Justices Allow the Term 'Tax' to Embrace 'Penalty'", *The New York Times, June 28*, 2012.

[7] The legal position of the Obama administration has been to argue that the portion of the obligation to purchase insurance tantamount to a tax is the penalty paid by those who do not meet this requirement. This penalty has a regulatory function: it is designed based on the logic of an incentive, and not from the perspective of new tax revenue. Judge Jeffrey Sutton explained that if the government had clearly specified that the obligation to buy insurance was a tax, it would have been easier to justify in terms of its constitutionality. Most tax allowances or tax rebates are positive incentives (tax breaks on the acquisition of cleaner vehicles, for example). The health insurance requirement acts instead as a negative incentive by imposing a penalty / fine on those who decide not to buy insurance. Faced with these alternatives, they will choose in all rationality – according to a Pigouvian perspective – the option that they consider the most profitable or the least costly.

[8] Ezra Klein, "Barack Obama, Bill Clinton and Health-Care Reform", *The Washington Post, July 26*, 2009.

[9] Robert Pear, "Obama Health Team Turns to Carrying Out Law", *The New York Times, April 18*, 2010.

[10] Medicaid is a public health insurance program for the poorest households (about 35 million beneficiaries). The numerous criteria (income, age, degree of invalidity, state of health, etc.) lead to excluding a non-negligible portion of society's poorest. Hence more than 20 million people living below the federal poverty level do not have access to Medicaid. On the other hand, Medicare, the other public health insurance program, which is only for those aged 65 and over, broadly covers this age group.

[11] Urban Institute-Health Policy Center, "Supreme Court Decision on the Affordable Care Act: What it Means for Medicaid", *Policy Briefs, June 28*, 2012.

[12] Genevieve M. Kenney, Lisa Dubay, Stephen Zuckerman and Michael Huntress, "Making the Medicaid Expansion an ACA Option: How Many Low-Income Americans Could Remain Uninsured?", *Policy Briefs, Urban Institute – Health Policy Center, June 29*, 2012.

[13] In the absence of an expansion of *Medicaid*, their health insurance spending will be capped at 2% of their income.

[14] This notion of voting with their feet was put forward in an article by Charles M. Tiebout (1956): "A Pure Theory of Local Expenditures", *The Journal of Political Economy*, 1956, vol. 64/5, pp. 416-424.

[15] Brett Norman, "Lew: 'Vast majority' of states will expand Medicaid", *Politico, 1st July 2012*.

[16] In 2022, 136 billion dollars will finance public health insurance for 17 million poor people (expansion of Medicaid) and 127 billion dollars will go to subsidies for the purchase of private insurance by 18 million people.

[17] In 2022, the 27 million uninsured remaining will consist of illegal immigrants (ineligible for public and private insurance programs) and those eligible for Medicaid who do not want to take out insurance as well as those ineligible for Medicaid who also do not want insurance.

[18] Susan Stamper Brown, "Time To Clean Up The Obamacare Mess", *The Western Center for Journalism, June 26, 2012*.