



CIGI PAPERS

NO.1 — DECEMBER 2011

FISCAL ASYMMETRIES AND THE SURVIVAL OF THE EURO ZONE

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First published in 2011 by The Centre for International Governance Innovation.

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ACKNOWLEDGEMENTS

The author would like to thank, without implicating, Ralph Bryant, Matthew Canzoneri, Xavier Debrun, Olivier Jeanne, Paul Jenkins and seminar participants at Georgetown University for useful discussions and Petra Dacheva for assistance with data.

ACRONYMS

| | | | |
|-------------|---------------------------------------|------|----------------------------------|
| ECB | European Central Bank | OCA | optimum currency area |
| EFSF | European Financial Stability Facility | SGP | Stability and Growth Pact |
| EMU | European Monetary Union | SUR | seemingly unrelated regression |
| EU | European Union | SVAR | structural vector autoregression |
| dem account | democratic accountability | VAR | vector autoregression |
| FN | financing need | YPC | per capita income |
| IT | inflation-targeting | | |

ABOUT THE AUTHOR

Paul R. Masson recently retired from the Rotman School of Management, University of Toronto, where he has also taught international finance to graduate students in the economics department. Paul has spent most of his career at official institutions: starting at the Bank of Canada in 1973 after receiving a Ph.D. from the London School of Economics. He then worked at the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund. He is currently associated with the National Bureau of Economic Research, Center for Economic and Policy Research and the C.D. Howe Institute, and was a visiting scholar at The Brookings Institution. During 2007-08, Paul served as special adviser to the Governor of the Bank of Canada. He has also consulted for the Bank for International Settlements, the Conference Board of Canada, the Dubai Economic Council and the World Bank.

Paul's research interests and publications have mainly been in the area of monetary economics, international money and finance, public finance, and macroeconomic modelling. He has published several books, including *Economic Cooperation in an Uncertain World*, with Atish Ghosh (Blackwell, 1994), *The Monetary Geography of Africa*, with Catherine Pattillo (Brookings Institution Press, 2005), and a textbook based on his course, *Topics in International Finance* (World Scientific, 2007). He has also published a number of articles on policy credibility, financial crises, contagion, exchange rate regimes, and financial regulation. A collection of some of his articles has recently appeared under the title *Currencies, Crises, Fiscal Policy, and Coordination* (World Scientific, 2011).

EXECUTIVE SUMMARY

The independence of the European Central Bank (ECB), seemingly guaranteed by its statutes, is presently under attack. The ECB has been led to acquire large amounts of government debt of the weaker euro zone members, both to help contain their interest costs and to help protect the solvency of banks throughout the zone that hold their debt. This paper presents a model of a dependent central bank that internalizes the government's budget constraint. Using a Barro-Gordon framework, the model embodies both the desire to stimulate output and to provide monetary financing to governments. As a result of the inability to pre-commit to first-best policies, the central bank produces excess inflation — a tendency partially reduced in a monetary union. The model implies that not only shock asymmetries, but also fiscal asymmetries, are important in the membership calculus of desirable monetary unions. On the basis of this framework, calibrated to euro zone data, the current membership is shown not to be optimal: other members would benefit from the expulsion of several countries, notably Greece, Italy and France. A narrow monetary union centred around Germany is sometimes mooted as a preferable alternative, especially if it could guarantee central bank independence. However, simulation results suggest that such a narrow monetary union would not be in Germany's interest: though better than the euro zone with a dependent central bank, it would not internalize enough trade to make it more attractive than the resumption of monetary autonomy by Germany.

INTRODUCTION

The current crisis in the euro zone has highlighted once again the strains put on a monetary union by the lack of fiscal discipline. While the interaction of fiscal and monetary policies is complex, supporters of monetary union have long argued that statutory central bank independence and credible restraints on fiscal policies would provide an adequate framework for the ECB to deliver the benefits of low inflation and monetary integration. The failure of the Stability and Growth Pact¹ (SGP) to enforce fiscal discipline has in turn led the ECB to violate the spirit, if not the letter, of the prohibition

¹ Euro zone governments agree to respect deficit and public debt ceilings of three and 60 percent of their GDPs, respectively, or face sanctions.

of bailouts in the Maastricht Treaty. The ECB has taken extraordinary measures to purchase debt of the crisis countries, among them Greece, Ireland, Portugal and Spain, raising concerns that monetary policy may be influenced by the financing needs of highly indebted countries. While the ECB has made clear that it intends to cease the extraordinary measures it has undertaken,² and euro zone institutions (the European Financial Stability Facility [EFSF], to be superseded by the European Stability Mechanism) have been set up to take its place, there is doubt about the effectiveness of those institutions. Pressures to provide direct or indirect monetary financing to governments may, therefore, undermine ECB independence in the future. Indeed, there are proposals to make the EFSF into a bank that could then obtain potentially unlimited liquidity from the ECB to buy euro zone government debt.

Central bank independence requires political support to be effective, and the euro zone suffers from the lack of other aspects of integration that would provide that support — strong regional political institutions or fiscal federalism. As noted above, the ECB was to be insulated from financing governments by statute, and the pressures on it were in addition to be minimized by effective controls on fiscal policies, but the latter have failed. As the only EU institution with the power to act swiftly and with substantial financial resources, the ECB was necessarily at the centre of policy responses to the recent financial turmoil. Moreover, some have argued that the very architecture of the euro zone requires the ECB to become a lender of last resort to governments (and not just banks): because countries are borrowing in “foreign” currencies (that is, they no longer can rely on liquidity provided by the national central bank if needed to redeem their debt), self-fulfilling debt crises are more likely. The central bank, by promising to provide liquidity in these cases, could prevent such debt crises from occurring — just as national central banks prevent bank runs (De Grauwe, 2011).

This paper explores what the polar case of absence of central bank independence might mean for the survival of the euro zone. The intention in doing so is to highlight the dangers that advocates of ECB bailouts seem to ignore. Using a model (Debrun et al., 2011) in which the central bank’s decisions are purely the result of weighing together national objectives — objectives that include both financing government spending and stimulating output as well as keeping inflation low — we consider what would constitute a sustainable composition for the euro zone. In particular, the set of countries depends on incentives for euro zone members to remain in the monetary union — and for the others to want to keep them in. In this model, fiscal asymmetries are very important in determining the composition of a sustainable monetary union: a country with low fiscal discipline would want to join a monetary union that is (somewhat) more disciplined than itself, because the union delivers lower inflation, but not if the disparity is too great (since in that case the country loses too much in monetary financing). Conversely, countries that exhibit a degree of fiscal discipline would not want to have as a member a country whose financing needs are too great, since this would put upward pressure on the union’s inflation rate. The model also includes the benefits of a common currency as well as the usual costs that result from optimum-currency-area shock asymmetries.

In evaluating the degree of fiscal discipline, two components need to be taken into account: the government’s overall spending objectives, on the one hand, and an additional amount that represents both wasteful government spending (such as outright corruption) and inefficiencies in tax collection, on the other hand. The model used calculates the overall financing need as the sum of these two components, and the composite variable provides a measure of the pressure on the central bank to increase inflation. The euro zone, at present, differs greatly in the extent of fiscal discipline due to both components. Greece, for example, has high spending commitments to its public employees because of generous benefits, while at the same time suffering from inefficient tax collection. An important part of this paper will be to estimate the asymmetries in these financing needs.

This paper provides welfare calculations using a calibrated version of the model, where welfare is assumed to depend on keeping inflation and taxes low, attaining targets for productive government expenditure and increasing output. For each country, two cases will be considered: remaining in the euro zone (whose

2 See, for instance, “Trichet rejects ECB role as lender of last resort,” *Financial Times*, October 4, 2011.

final composition may remain to be determined), and abandoning the union and reintroducing a national currency. At the same time, countries in the euro zone would be given the choice of expulsing a country if this would increase the welfare of the remaining members. This exercise provides insights into what configuration of countries may constitute a stable core that would be sustainable, assuming that the current political framework for the euro zone remains in place, but that the ECB is unable to maintain independence from national government budget constraints.

An important issue concerns whether some countries — in particular Germany — can guarantee the independence of their central bank or, indeed, of a narrow regional central bank that is formed around Germany and shares that independence with respect to the fiscal authorities. The controversy over current ECB policies largely reflects the unhappiness of the German government with bailouts, and a smaller euro zone with more disciplined members might be able to re-establish ECB independence. The paper thus considers what possible configurations might be consistent with such an independent, inflation-targeting (IT) central bank.

The plan of the paper is as follows. The next section provides a short summary of a model of a dependent central bank, which is compared to a simple model of an IT, independent central bank that does not internalize government borrowing constraints. Next, it deals with calibration to the euro zone — which, until recently, has behaved much as an independent, IT central bank. It then focuses on fiscal asymmetries among euro zone members. The following section provides welfare comparisons for individual euro zone countries that remain in the monetary union versus reintroducing their own currencies and once again having their own monetary policies — independent or not from the fiscal authorities. In addition, an assessment is made of whether the welfare of the remaining euro zone members would be increased by that country's departure. Special attention is given to Germany, given the proven track record of the Bundesbank to deliver on a commitment to low inflation, its independence and public support for its uncompromising position. The final section provides some conclusions and caveats.

A MODEL OF A DEPENDENT REGIONAL CENTRAL BANK

Much has been written on the credibility of central banks' commitment to low inflation. It is now generally accepted that an independent central bank — with instrument independence, but not necessarily the independence to set its own goals — is best placed to achieve a rate of inflation that approaches society's optimum level (DeBelle and Fischer, 1994). That level may be zero or even negative (Friedman, 1969), while central banks that are forced by fiscal dominance to finance government budgets are likely to produce suboptimally high inflation. A further, and related, question is whether even independent central banks can pre-commit not to use monetary policy to stimulate economic activity. Such a policy is self-defeating, since a systematic attempt to do so is built into the expectations of the private sector, and the monetary stimulus, therefore, has little or no effect.

The interaction between monetary and fiscal policy is made even more complicated in a common-currency area grouping countries with independent fiscal policies, but facing a single monetary policy decided by a supranational central bank.³ Fears that the monetary union would create perverse externalities for fiscal policies and free-riding behaviour led the European Union to institute fiscal criteria for public deficits and debt as preconditions for membership, and to require members of the European Monetary Union (EMU) to subscribe to the SGP with potential penalties for those that did not comply with its provisions. In practice, there have been numerous cases of countries (including Germany and France) exceeding the three percent of GDP fiscal deficit ceiling and the 60 percent public-debt-to-GDP ratio, but penalties were never assessed, and the SGP was weakened in 2005.

In this paper, the consequences for the euro zone of the ECB internalizing the budget constraints of member governments are studied — that is, becoming a “dependent central bank” in the terminology used here. Such

³ For a recent survey of the extensive academic literature on this subject, most of which addresses the European context, see Beetsma and Giuliodori (2010).

an outcome would have seemed almost inconceivable a few years ago; after all, the Maastricht Treaty explicitly ruled out monetary financing of government budgets (Article 123 of the Treaty on the Functioning of the European Union), and bailing out countries in trouble⁴ (Article 125). However, recent events have shown that loss of ECB independence is now an all-too-real possibility. European public finances are in dire straits, and the rudimentary EU structural funds and the newly created EFSF are inadequate to bail out all the governments with severe debt sustainability problems. Fears of default have led to sharp increases in the interest rates prevailing on several governments' marketable debt. As a result, the ECB has purchased, in secondary markets,⁵ large amounts of the government debt of the most highly indebted euro zone countries — including Greece, Ireland, Italy, Portugal and Spain. By lowering their borrowing costs, it hopes to make their debt more sustainable and avoid a default. Default would endanger the solvency of commercial banks in the euro zone, which hold large amounts of the debts of these countries, and the fiscal authorities of all the euro zone countries would then face further large expenditures required to recapitalize their banks.

While independent central banks have been extensively modelled — in particular those targeting inflation⁶ — the operation of a dependent regional central bank in the European context has not, so far, received attention. To date, pressures to finance government deficits have been thought mainly to be the lot of central banks in Africa or Latin America. The implications of internalizing governments' budget constraints in the context of African regional monetary integration have been studied by Debrun et al. (2005, 2008, 2011), and Masson and Pattillo (2005). Clear criteria emerge for the composition of monetary unions that are both desirable and feasible; that is, the country joining should improve its welfare by doing so and the existing members should also be willing to accept it as a member. In addition to the usual consideration under optimum currency area (OCA) theory that shocks should not be too asymmetric, fiscal discipline (that is, financing needs) should not differ too radically. Countries would like to be members of a monetary union with countries that do not require much larger financing (as a proportion of GDP) than themselves — and, ideally, somewhat less. Nevertheless, a monetary union may be attractive when compared to independent currencies, because by internalizing trade within a common monetary area, the temptation to produce counter-productive monetary stimulus is reduced. It is assumed that neither the national nor the regional central bank can pre-commit not to provide that monetary stimulus and, hence, the first-best outcome cannot be attained.

Specifically, national central banks are assumed to reflect the same objectives as the government (and society) — namely, targeting useful government spending, keeping taxes low, minimizing the deviations of inflation around its target and increasing output.

$$U_i^G = \frac{1}{2} \left\{ -a(\pi_i - \tilde{\pi}(\varepsilon_i))^2 - b\tau_i^2 - \gamma(g_i - \tilde{g}_i)^2 \right\} + y_i \quad (1)$$

The linear term in output is analytically convenient and has the same effect as targeting a level of output that is greater than the “natural rate” in Barro and Gordon (1983). The objective for inflation reflects a stabilization motive: a negative supply shock leads to a temporarily higher target for inflation. We parameterize this by making the inflation target inversely proportional to the output shock ε :

$$\tilde{\pi}(\varepsilon_i) = -\eta\varepsilon_i \quad (2)$$

The fact that the central bank internalizes the financing needs of the government leads to higher inflation, since optimal policy involves equalizing the marginal costs of raising taxes and inflation. In addition to productive

4 “The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.” (Article 123.1 of the Treaty on the Functioning of the European Union)

5 Thus getting around the prohibition in Article 21 of the ECB's Statutes against purchasing debt directly from government entities. However, the distinction here is nearly meaningless, since purchasing debt in secondary markets also influences the cost of debt issuance in primary markets — which is the real purpose of the ECB's actions.

6 See, for instance, Svensson (1999, 2000), Bernanke et al. (1999), and Clarida, Galí, and Gertler (1999).

spending needs, the government also engages in wasteful spending δ , linked to corruption and rewarding of supporters, as well as inefficiencies in tax collection that add to financing needs. Thus, the government's budget constraint (all terms are ratios to GDP) can be written as

$$g_i = \mu\pi_i + \tau_i - \delta_i \quad (3)$$

where useful (that is, welfare inducing) government spending is financed by seigniorage and taxes, respectively, and reduced by wasteful spending and diversion.

The model is built around a Barro-Gordon supply equation (Barro and Gordon, 1983), as modified by Alesina and Tabellini (1987) to include the negative effects of taxes, and extended to the open economy. The log of output y depends on output surprises both at home and (with negative transmission) abroad, the latter depending on the strength of bilateral trade ties θ :

$$y_i = c(\pi_i - \pi_i^e - \tau_i) - \sum_{k \neq i, k=1}^n \theta_{i,k} c(\pi_k - \pi_k^e) + \varepsilon_i \quad (4)$$

Monetary policy maximizes (1) with respect to inflation, subject to equations (2) through (4). It chooses inflation after observing the shock to output. Since it acts after private sector expectations are formed, it has an incentive to produce monetary surprises to moderate the effect of supply shocks. In the open economy, this has spillover effects on other countries as well, provided countries do not use the same currency and, hence, cannot change their bilateral exchange rate. The government maximizes (1) with respect to taxes and government spending, linked by the budget constraint (3).

The Nash equilibrium, found by solving the first order conditions together, gives an intuitive explanation of monetary and fiscal policies when the central bank is not independent. Optimal inflation and taxes can be written in this context in terms of *financing need* (FN) ($FN = \tilde{g}_i + \delta_i$), which includes both legitimate spending objectives and wasteful spending/tax diversion. Both policy variables also depend on the shock to output:

$$\pi_i^* = \frac{\gamma ub}{\Lambda} FN_i + \frac{(b + \gamma) + \gamma\mu}{\Lambda} c - \frac{a(b + \gamma)\eta}{\Lambda} \varepsilon_i \quad (5)$$

$$\tau_i^* = \frac{\gamma a}{\Lambda} FN_i - \frac{\gamma\mu(1 + \mu) + a}{\Lambda} c + \frac{a\gamma\mu\eta}{\Lambda} \varepsilon_i \quad (6)$$

where all parameters are assumed to be positive and $\Lambda = a(b + \gamma) + \gamma\mu^2 b > 0$. As can be seen from the first term of equation (5), the central bank partially accommodates the financing needs of the government. The second term also contributes to raising inflation, because of the inability to pre-commit. The third term embodies the use of monetary policy to offset (partially) output shocks. The reduced form for taxes also embodies the financing motive, but given positive inflation and hence seigniorage, taxes can be lower than they would be otherwise. The third term again allows for the effect of inflation on government financing, given monetary policy's stabilization role. This framework, though not dynamic and hence not suitable to explain the time series evolution of inflation, provides a reasonable explanation of the cross-sectional variations in inflation rates when calibrated to African data (Debrun et al., 2011).

When used to analyze currency unions, this simple model also produces some insights that extend those of the usual OCA model. The regional central bank is also assumed not to be independent of the governments of member countries: it internalizes the budget constraints of the governments weighted together according to their relative economic size ϖ_i . It maximizes

$$U_{MU} = \sum_{i \in MU} \varpi_i U_i^G \quad (7)$$

with respect to the common rate of inflation, subject to the same constraints as before. However, the fact that there are several governments facing a single central bank affords the latter a measure of independence from countries taken individually. This, in itself, reduces the bias toward excessive inflation. The central bank of a

grouping of countries has less of an incentive to stimulate the economy through higher inflation to the extent that it internalizes a larger proportion of the region's trade. Optimal inflation in this case is given by

$$\pi_{MU}^* = \frac{\gamma ub}{\Lambda} FN_{MU} + \frac{(1 - \theta_{MU})(b + \gamma) + \gamma \mu}{\Lambda} c - \frac{a(b + \gamma)\eta}{\Lambda} \varepsilon_{MU} \quad (8)$$

with the MU subscript indicating ϖ_i -weighted averages. This solution (which embodies the same optimization as before by governments, taking inflation as given) has the same form as (5), with two differences: both financing needs and the shock are now averaged over all countries in the monetary union, while the bias term is reduced by the amount of trade internalized in the monetary union, θ_{MU} . The latter reflects the reduced temptation to stimulate output, since the scope for beggar-thy-neighbour expansion at the expense of trading partners is reduced.

The fact that the central bank reflects the average financing need of member countries in its decision making (as well as the average shock) means that the fiscal discipline of potential members of a monetary union becomes very important. A comparison of the expected gain in welfare for a given country i of being a member versus having its own currency, gives the following:

$$E_{-i} G_i = \frac{\theta_A(2 - \theta_{MU})(b + \gamma)}{2\Lambda} c^2 + \frac{\gamma ub(1 - \Psi_i)}{\Lambda} FN_i \left[(1 - \theta_{MU}) c - \frac{\gamma ub(1 - \Psi_i)}{2(b + \gamma)} FN_i \right] - \frac{a^2 \eta^2 (b + \gamma) (1 - \omega_i)^2}{2\Lambda} [\sigma_{\varepsilon_i}^2 + \sigma_{\bar{\varepsilon}_{-i}}^2 - 2\text{cov}(\varepsilon_i, \bar{\varepsilon}_{-i})] \quad (9)$$

where $\Psi_i = FN_{MU} / FN_i$ is a measure of the fiscal asymmetry of country i compared to the other members. The first term measures the increase in welfare due to the reduced temptation to inflate, because some of the effects are internalized; this is referred to below as the “monetary externality” term. The second term captures the effects of fiscal asymmetries on welfare, and the last term reflects the reduction in welfare due to shock asymmetries ($\bar{\varepsilon}_{-i}$ is the average shock in the monetary union, excluding country i).

The second term is ambiguous in sign: countries would like to import fiscal discipline, that is, be part of a monetary union with somewhat lower average financing needs than their own; however, too much fiscal discipline would reduce its share of seigniorage too greatly, so there is a trade-off here. This feature also has a certain amount of relevance to the euro zone, as the current crisis illustrates.

The dependent central bank model can be contrasted with a simple model of an independent, IT central bank. Here, we once again assume that the monetary authorities cannot pre-commit to not use monetary stimulus to raise output above its “natural rate.” However, they do not internalize the government's budget constraint, so that their objective function includes only inflation and output:

$$U_i^{IT} = \frac{1}{2} \left\{ -a(\pi_i - \tilde{\pi}(\varepsilon_i))^2 \right\} + y_i \quad (10)$$

Optimal policy for an IT central bank is simply to target a mean inflation rate of c/a , reflecting the desire to stimulate output (the equivalent of k in the Barro-Gordon formulation, which in their model measures the attempt of the central bank to offset distortions in the economy that imply that the natural rate is too low), plus a term that involves offsetting shocks to output. Thus,

$$\pi_i^{IT} = \frac{c}{a} - \eta \varepsilon_i \quad (11)$$

A central bank in a monetary union again would maximize a GDP-weighted average of this objective function, so it would target overall inflation and output of the union — and, hence, respond to the average shock, but would also have a reduced temptation to stimulate the economy because of the amount of trade internalized:

$$\pi_{MU}^{IT} = (1 - \theta_{MU}) \frac{c}{a} - \eta \varepsilon_{MU} \quad (12)$$

The relevant criterion for joining a monetary union if central banks can commit to IT (including that of the union itself), therefore involves weighing just two elements: the monetary externality versus the inability to respond to country-specific shocks. The fiscal asymmetry would not affect the attractiveness of potential monetary union partners, since the central bank does not internalize government budget constraints. In what follows, however, we evaluate Germany's incentive to remain in the euro zone versus having an autonomous, independent monetary policy using society's welfare function, equation (1), not the more restricted objective function (10) assigned to the Bundesbank. The decomposition presented above (equation 9) is no longer possible in this case, since the expressions for inflation rates no longer have the same form.

CALIBRATION OF THE MODEL TO THE EURO ZONE

In this section, the calibration of the model to the euro zone is described. In particular, the model requires estimates of output supply shocks, seigniorage and the extent of bilateral trade among euro zone members. In addition, the weights given to deviations of inflation, taxes and government spending from targets are estimated, such as to be consistent with the euro zone's average values for key variables and those of countries before they joined.

SHOCK ASYMMETRIES

In order to estimate shock asymmetries, we use a Blanchard-Quah⁷ identification of output supply shocks in a two-variable structural vector autoregression (SVAR), with dependent variables being the change in the log of real GDP and the change in the log of the GDP deflator. The long-run effect of demand shocks was constrained to not have any effect on real output. Estimates were obtained with four lags using SVAR in Stata,⁸ on non-seasonally adjusted quarterly data from 1999 to 2010 (or shorter period when not available). Table 1 gives the estimated standard deviations of the supply shocks, while Table 2 presents the correlations among the shocks for euro zone countries.

7 Blanchard and Quah (1989), as modified by Bayoumi and Eichengreen (1992) to identify the standard deviation of the shocks.

8 Stata is a widely used statistical software package. See: www.stata.com.

Table 1: Euro Zone: Standard Deviations of Annualized Output Growth, Inflation and Supply Shocks 1/

| Country | Rates of Growth and Shocks, 2000Q1–2010Q4 | | Inflation rate 1/ |
|-------------|---|-----------------|-------------------|
| | Output growth 1/ | Supply shock 2/ | |
| Austria | 2.74 | 1.07 | 0.25 |
| Belgium | 2.72 | 1.93 | 0.51 |
| Cyprus | 2.80 | 2.26 | 11.98 |
| Estonia | 9.29 | 6.21 | 3.19 |
| Finland | 5.35 | 4.69 | 0.96 |
| France | 2.23 | 1.57 | 0.40 |
| Germany | 3.62 | 3.30 | 0.49 |
| Greece | 5.48 | 3.83 | 1.22 |
| Ireland | 8.04 | 6.39 | 2.71 |
| Italy | 3.01 | 2.06 | 0.82 |
| Luxembourg | 16.16 | 7.51 | 4.52 |
| Malta | 6.88 | 6.33 | 9.66 |
| Netherlands | 2.80 | 2.14 | 0.99 |
| Portugal | 3.44 | 2.84 | 0.87 |
| Slovakia | 7.24 | 6.11 | 2.16 |
| Slovenia | 6.40 | 5.56 | 1.89 |
| Spain | 2.67 | 0.80 | 0.62 |
| Euro zone | 2.65 | 1.80 | 0.83 |

1/ 400 times quarterly change in the log of GDP and in the log of the GDP deflator.

2/ Residuals from Blanchard-Quah decompositions, multiplied by 400

Sources: IMF World Economic Outlook data, and author's calculation of supply shocks.

As for correlations, they are typically around 0.5 or higher for core western European countries, but are lower for some of the smaller and newer members. Greece stands out as having several negative correlations, as well as having only small positive correlations with a number of other euro zone participants.

Table 2: Euro Zone: Correlations of Supply Shocks

| Country | Austria | Belgium | Cyprus | Estonia | Finland | France | Germany | Greece | Ireland | Italy | Luxembourg | Malta | Netherlands | Portugal | Slovakia | Slovenia | Spain |
|-------------|---------|---------|--------|---------|---------|--------|---------|--------|---------|-------|------------|-------|-------------|----------|----------|----------|-------|
| Austria | 100% | | | | | | | | | | | | | | | | |
| Belgium | 55.2% | 100% | | | | | | | | | | | | | | | |
| Cyprus | 18.6% | 15.1% | 100% | | | | | | | | | | | | | | |
| Estonia | 23.1% | 33.5% | 34.4% | 100% | | | | | | | | | | | | | |
| Finland | 42.2% | 60.7% | 40.7% | 58.9% | 100% | | | | | | | | | | | | |
| France | 37.5% | 41.8% | 38.0% | 43.5% | 60.5% | 100% | | | | | | | | | | | |
| Germany | 44.4% | 59.2% | 27.6% | 38.7% | 67.7% | 59.1% | 100% | | | | | | | | | | |
| Greece | -15.8% | -6.0% | 20.9% | 23.3% | 11.9% | 17.4% | 7.4% | 100% | | | | | | | | | |
| Ireland | 21.9% | 20.1% | 35.8% | 39.7% | 27.2% | 30.8% | 23.5% | 6.7% | 100% | | | | | | | | |
| Italy | 56.5% | 52.0% | 18.4% | 27.6% | 59.0% | 63.3% | 72.8% | 6.8% | 20.2% | 100% | | | | | | | |
| Luxembourg | 30.6% | 47.8% | 23.5% | 49.6% | 41.5% | 30.6% | 52.6% | -13.1% | 14.3% | 48.0% | 100% | | | | | | |
| Malta | 14.2% | 25.7% | 35.4% | -3.5% | 27.0% | 39.3% | 29.9% | -17.2% | 20.3% | 16.4% | 12.2% | 100% | | | | | |
| Netherlands | 32.1% | 27.0% | 28.3% | 48.3% | 52.1% | 50.7% | 58.0% | 26.4% | 21.2% | 44.6% | 38.6% | 21.7% | 100% | | | | |
| Portugal | 36.1% | 33.8% | 17.5% | 37.2% | 52.7% | 36.0% | 52.3% | -1.9% | 31.9% | 53.6% | 42.0% | 25.6% | 51.5% | 100% | | | |
| Slovakia | 18.4% | 21.8% | 25.8% | 29.3% | 29.5% | 5.6% | 36.4% | 13.3% | 26.4% | 10.9% | 22.3% | 6.0% | 40.3% | 32.6% | 100% | | |
| Slovenia | 20.1% | 53.4% | 43.3% | 32.2% | 80.1% | 56.6% | 67.8% | 18.3% | 21.9% | 57.8% | 28.1% | 47.0% | 46.4% | 52.4% | 26.6% | 100% | |
| Spain | 52.8% | 36.3% | 28.5% | 40.3% | 39.7% | 30.5% | 32.3% | -6.8% | 18.4% | 25.5% | 32.2% | 10.7% | 39.7% | 35.9% | 36.6% | 26.0% | 100% |

Source: Author's calculations.

BASE FOR THE INFLATION TAX

Though we refer to the direct effect of inflation on the government's budget constraint as seigniorage, in fact what we want is the total impact of higher inflation in financing the government. The tax rate τ in our model is assumed to be a proportional tax on income (and τ is constant for given *FNs* and shocks to output, whatever the rate of inflation). In practice, tax revenues as a ratio to nominal GDP tend to increase with inflation for two principal reasons: with a progressive personal income tax system, bracket creep leads to higher marginal and average tax rates (Bailey, 1976); and with a corporate tax system in which depreciation allowances are based on historical costs, effective tax rates rise with inflation (Nichols, 1968). Thus, to the extent that tax brackets and depreciation allowances are not fully indexed, the tax take will tend to increase with inflation.⁹

The cost of servicing bonds with fixed nominal coupons will also decline as a ratio to GDP, but this is only true if the higher inflation was unanticipated. More complicated to estimate is the possible link between bailing out governments by buying their securities and future inflation. To the extent that bond purchases do not have a cost for the central bank, there would not be implications for its solvency. But if the ECB faced losses from defaults on the sovereign paper that it acquired, it might be led to finance them by higher inflation, increasing its seigniorage and that of the national central banks of the Eurosystem. This issue is not pursued in this paper.

The ECB provides estimates of seigniorage, but this is very small. The ECB's eight percent share of euro zone seigniorage averaged about €400 million per year over 2006–08 (ECB, 2010). Hence, the total seigniorage of the Eurosystem (including both the ECB's share and the remaining 92 percent share divided among the national central banks) is about €5 billion. If we relate this to the euro zone's average annual GDP over this period (about €12,180 billion), seigniorage is only about 0.04 percent of GDP. Since actual inflation averaged 2.5 percent, if seigniorage were proportional to inflation, the factor of proportionality μ would equal 0.016.

A much larger potential effect results from the non-indexation of the personal and corporate tax systems, described above. While at present there are no detailed estimates for euro zone countries, the evidence that exists suggests that they could be sizeable. For instance, a study of the evolution of wage tax wedges over 2001–06 estimates that fiscal drag contributed to raising wage tax wedges by an average of about two percentage points in euro zone countries (OECD, 2007). Since cumulative nominal income growth¹⁰ in the euro zone was about 10 percent over that period, the marginal effect seems to average about one-fifth. As for the effect on corporate taxes, data are hard to obtain, but Feldstein (1981) estimated that the effect of an eight percent expected inflation rate would be to raise the real net cost of an equipment investment with a 13-year tax life by 21 percent if the firm used a four percent real discount rate, due to a decline in the real value of depreciation allowances.

In our preliminary simulations of monetary unions in Europe, a figure of 0.25 is used for the combined effect of euro zone inflation on increased financing of government budgets: that is, one percentage point increase in inflation increases the ratio of taxes to GDP by one-quarter of a percentage point.

EURO ZONE TRADE

An important component of the estimated gain from a monetary union is the reduced temptation to engineer inflation surprises and, thus, stimulate output. In the model, this reduced temptation is related to the amount of trade internalized in the monetary union.

Countries will, therefore, be more apt to welcome, as a member of the monetary union, a country that already trades a lot with existing members. Table 3 below gives the fraction of each euro zone member's total exports accounted for by other euro zone countries, as well as the ratio of each country's total trade to its GDP.

⁹ This is quite separate from the Oliveira-Tanzi effect (Tanzi, 1977), which suggests that the real value of tax receipts declines with inflation, as there is a lag between the establishment of the tax liability and the actual payment of taxes. This effect is likely to be significant only at high rates of inflation, unless collection lags are very long.

¹⁰ Fiscal drag results from both inflation and real growth.

| Country | Total Exports/GDP (% of GDP) | Exports to Euro Area (% of total) |
|-----------------|---|--|
| Austria | 43.62 | 53.81 |
| Belgium | 93.52 | 63.49 |
| Cyprus | 6.44 | 37.85 |
| Estonia | 52.62 | 31.51 |
| Finland | 35.63 | 32.32 |
| France | 21.71 | 49.69 |
| Germany | 39.69 | 42.76 |
| Greece | 7.62 | 44.17 |
| Ireland | 47.43 | 40.78 |
| Italy | 23.40 | 44.21 |
| Luxembourg | 43.76 | 72.07 |
| Malta | 34.25 | 35.62 |
| Netherlands | 73.00 | 62.39 |
| Portugal | 22.67 | 64.75 |
| Slovak Republic | 75.03 | 48.35 |
| Slovenia | 62.41 | 50.90 |
| Spain | 17.55 | 56.37 |

Sources: IMF Direction of Trade Statistics and International Financial Statistics.

Most euro zone countries are very open, with a high ratio of total exports to GDP. Notable exceptions are Greece and Cyprus, and to a lesser extent, Spain. Moreover, much of that trade is with other euro zone countries — over 40 percent except for peripheral countries such as Cyprus, Estonia, Finland and Malta.

BEHAVIOURAL PARAMETERS

The model has been adapted to the euro zone to reflect EU trade patterns and shock correlations, as well as estimated fiscal demands on the central bank (see next section Fiscal Asymmetries). Parameters c and η were chosen to reflect variances of output and inflation relative to estimated supply shocks. In addition, the weights a , b , γ were selected to reflect the average data for inflation, taxes and government spending. The experience of the euro zone, assumed to be the result of inflation targeting by an independent central bank, and the data for a dependent central bank such as Italy's in the 1980s are both used.

In particular, an independent central bank that did not internalize the government's budget, but simply targeted inflation and output, would produce an average inflation rate equal to c/a for a single country's central bank and $c(1 - \theta_{MU})/a$ for a regional central bank. Using a figure of 2.5 percent for average inflation in the euro zone over its first decade, and the estimate for $c=2.208$ based on the variance of the euro area's output, gives a value for a of

$$a = c(1 - \theta_{MU}) / 2.5 = 2.208(1 - 0.1712) / 2.5 = 0.7319$$

As for η , it is calibrated based on the variance of inflation relative to the variance of supply shocks. An inflation-targeting independent central bank would produce a standard deviation of inflation equal to η times the standard deviation of the average euro zone supply shock. The standard deviation of euro zone annualized inflation is 0.84. This gives

$$\eta = stdev(\pi) / stdev(\varepsilon) = 0.84/1.80 = 0.4643$$

The experience of non-independent central banks is needed to calibrate b and γ . As a rough stylized fact, average values for inflation, tax rates and financing need equal to 10, 50 and 52.5 were used to calibrate their values, conditional on the other estimates given above.

The resulting parameter estimates used in the simulations are as follows:

| Parameter | Value |
|---------------|--------|
| a | 0.7319 |
| b | 0.1565 |
| c | 2.2079 |
| η | 0.4643 |
| γ | 4.0089 |
| μ | 0.25 |
| Λ | 3.0880 |
| θ_{MU} | 0.1712 |

It is not being claimed that this model captures all the features that are relevant for monetary policy in Europe. The model is not dynamic and, thus, is not well adapted to explain the time series variations of inflation or of government debt accumulation. It is of interest, however, to see how such a simple framework may shed light on the possible forces at work as the euro zone faces attacks on its integrity and speculation about its disintegration or the expulsion of certain members.

FISCAL ASYMMETRIES

The model identifies an important structural variable, called FN , which measures the pressure each country exerts on the monetary union's central bank to provide monetary financing. This variable has two components: the country's fiscal target for useful government spending, and a wedge in the government's budget constraint between government spending and tax and seigniorage revenues. This wedge results from inefficiencies in tax collection and wasteful spending that does not contribute to society's welfare — for example, outright corruption by public officials and rewarding of government supporters.

The two components of FN for each country consist of society's target for government spending, \tilde{g} , and a diversion wedge δ . Aggregate government revenues and expenditures on governance indicators are regressed to gauge directly what amounts of excess spending and tax losses are due to poor governance. The governance indicators are then set to their "ideal" levels: the resulting figure for ideal government spending gives the estimate for \tilde{g} , and the difference between the ideal and actual figures for the deficit provides the estimate for δ . Thus,

$$FN = \tilde{g} + \delta = g | ideal + (\tau - g) | ideal - (\tau - g)$$

This can be further simplified as follows:

$$FN = \tilde{g} + \delta = \tau | ideal - (\tau - g) = (\tau | ideal - \tau) + g$$

The difference between ideal and actual tax revenues, plus the actual government spending to compute financing need, is therefore used.

The effects of poor governance were captured using International Country Risk Guide indicators for the 27 EU countries and dates for which they and the other explanatory variables were available (PRS Group, 2011). For some of the 2005 accession countries, data begin in 2000; it was decided to exclude the data from the depth of the recent crisis with its large, and hopefully temporary, widening of deficits. Therefore, an eight-year average (2001–08) was used, and it was assumed that this captured long-run, sustainable levels for the components of FN .

Some experimentation was done to find those indicators with significant effects on revenues; only governance indicators at the five percent level were retained. The model also controlled for per capita income, since revenues and expenditures seem to depend systematically on that variable. However, the relationship is not monotonic, hence per capita income squared was also included. Per capita income is assumed to affect revenues and expenditures equally, therefore, it would have no systematic effect on the deficit. Seemingly unrelated regression (SUR) was used to estimate equations for revenues and the fiscal position expressed as ratios to GDP. Per capita income (YPC) is expressed in US dollars, while the governance indicators are indexes ranging from 0 to 6 — for corruption and democratic accountability (dem account) — with in each case higher values indicating better governance. YPCSQ is per capita income squared. The results of the estimation are given below.

| Table 4: Cross Section Estimation, Seemingly Unrelated Regressions | | | | | | | |
|--|---------------------|--------------------------------------|------------|----------|--------|-------|---------|
| | Equation | (All EU countries, averages 2001-08) | | | R-sq | chi2 | P-value |
| | | Observations | Parameters | RMSE | | | |
| (1) | Revenues/GDP | 27 | 3 | 4.15299 | 0.5804 | 36.81 | 0 |
| (2) | Fiscal position/GDP | 27 | 2 | 1.924414 | 0.4169 | 19.99 | 0 |
| | | Coefficient | Std. Error | z | P>z | | |
| (1) | Revenues/GDP | | | | | | |
| | YPC | 0.2892 | 0.1786 | 1.62 | 0.105 | | |
| | YPCSQ | -3.36E-03 | 1.82E-03 | -1.85 | 0.064 | | |
| | corruption | 3.19187 | 1.228976 | 2.6 | 0.009 | | |
| | constant | 26.15679 | 2.931107 | 8.92 | 0 | | |
| (2) | Fiscal position/GDP | | | | | | |
| | corruption | 1.558015 | 0.3544836 | 4.4 | 0 | | |
| | dem account | -2.4707 | 1.050482 | -2.35 | 0.019 | | |
| | constant | 6.863744 | 5.664158 | 1.21 | 0.226 | | |

The system of equations does a reasonably good job in explaining the cross-country variation in general government revenues and fiscal positions. Revenues are positively related to per capita income, but the relationship flattens out with higher income levels, reaching a maximum at a per capita income equal to \$43,006 before turning down. Less corruption (a higher value of the variable) increases both revenues and the fiscal position (but the latter by less). Greater democratic accountability reduces the fiscal position; this can be explained in terms of the compromises reflected in the political process and the need to attract voters in order to improve the incumbents' chances of re-election.

The SUR estimates of the revenue equation were used to estimate the "ideal" revenues in equation (1), which determines the financing need, as follows. First, all the countries were put on the same footing by adjusting revenues to what they would be if all countries had the same per capita income as the EU average and ideal values for corruption. Then actual government spending was added.

Thus, using the SUR estimates of Table 4 the financing need is calculated as:

$$FN = 0.289(26.98 - YPC) - 3.36 \cdot 10^{-3}(26.98^2 - YPCSQ) + 3.19(6.0 - corruption) + g$$

where YPC is in thousands of dollars, $YPSQ$ is in millions and \$26,980 is the mean per capita income of EU countries on average over 2001–08.

Table 5 reports the calculated values for FN , as well as the values of the variables used in the calculation.

It can be seen that several countries have high values of *FN*. In particular, going in descending order, the worst performers among euro zone countries are France, Italy, Greece and Belgium, while among the non-euro zone members, Hungary, Poland and the Czech Republic are the highest. Among the euro zone members, the high financing need in France is due primarily to high government spending as ratio to GDP, while in Italy and Greece, to poor values for corruption.

| Country | (Averages, 2001–08) | | | Corruption |
|-----------------|---------------------|----------|-------|------------|
| | FN | YPC | g | |
| Austria | 53.65 | \$35,728 | 50.83 | 4.94 |
| Belgium | 56.17 | \$34,472 | 49.81 | 3.84 |
| Bulgaria | 52.54 | \$3,752 | 35.58 | 2.00 |
| Cyprus | 48.89 | \$21,826 | 41.88 | 4.00 |
| Czech Republic | 57.43 | \$12,092 | 44.65 | 2.71 |
| Denmark | 54.43 | \$45,540 | 53.40 | 5.49 |
| Estonia | 46.94 | \$10,291 | 35.26 | 3.18 |
| Finland | 48.49 | \$36,470 | 49.09 | 6.00 |
| France | 60.32 | \$32,652 | 52.95 | 3.55 |
| Germany | 50.52 | \$33,030 | 46.34 | 4.53 |
| Greece | 57.37 | \$21,010 | 45.74 | 2.59 |
| Hungary | 61.82 | \$10,189 | 49.65 | 3.02 |
| Ireland | 42.23 | \$45,409 | 34.24 | 3.33 |
| Italy | 58.93 | \$29,096 | 48.13 | 2.55 |
| Latvia | 52.06 | \$7,681 | 36.37 | 2.10 |
| Lithuania | 49.06 | \$7,706 | 34.31 | 2.39 |
| Luxembourg | 48.16 | \$79,009 | 39.64 | 5.00 |
| Malta | 54.68 | \$14,567 | 44.34 | 3.31 |
| Netherlands | 47.95 | \$38,022 | 45.73 | 5.10 |
| Poland | 58.47 | \$8,053 | 43.51 | 2.30 |
| Portugal | 49.91 | \$17,515 | 41.89 | 3.88 |
| Romania | 48.72 | \$4,693 | 33.44 | 2.45 |
| Slovak Republic | 52.05 | \$11,125 | 38.90 | 2.66 |
| Slovenia | 52.60 | \$17,627 | 42.10 | 3.10 |
| Spain | 46.23 | \$24,777 | 39.01 | 3.82 |
| Sweden | 53.37 | \$39,675 | 51.62 | 5.24 |
| United Kingdom | 44.27 | \$35,955 | 39.82 | 4.40 |

Sources: *FN* calculation as described in text; ICRG data used for corruption; IMF International Financial Statistics and World Economic Outlook data for remaining variables.

SHOULD THE EURO ZONE BE SHRUNK OR DISBANDED?

The model is then applied to the euro zone in order to compare the welfare to existing euro zone members of a smaller monetary union. In turn, the welfare gain or loss for the member who leaves the euro zone is calculated. In each case, as discussed above, several factors come into play: the extent of trade internalized in the monetary union, the size of a country, its financing need and the asymmetry of its supply shocks when

compared to the average for the monetary union. The welfare gains and losses are presented in the following tables, with details concerning the factors mentioned above. In each case welfare is evaluated using equation (1), with the same parameter values for all countries. It is measured in terms of GDP equivalents: that is, a one percent welfare gain corresponds to the increase in welfare that would result from a permanent increase in GDP of one percent.

| Country | GDP Share | Shock Correlation | FNmu/FN | Welfare Gain | Decomposition of welfare gain | | |
|-------------|-----------|-------------------|---------|--------------|-------------------------------|------------------|-----------------|
| | | | | | Monetary Externality | Fiscal Asymmetry | Shock Asymmetry |
| Austria | 3.1% | 54.9% | 1.00 | 0.84 | 1.03 | 0.01 | -0.19 |
| Belgium | 3.7% | 63.7% | 0.95 | 1.03 | 1.03 | 0.28 | -0.24 |
| Cyprus | 0.2% | 37.4% | 1.10 | 0.09 | 1.03 | -0.55 | -0.48 |
| Estonia | 0.2% | 51.3% | 1.14 | -2.47 | 1.03 | -0.79 | -2.84 |
| Finland | 2.0% | 77.6% | 1.11 | -0.42 | 1.03 | -0.60 | -0.95 |
| France | 20.9% | 76.6% | 0.89 | 1.50 | 1.03 | 0.71 | -0.11 |
| Germany | 26.8% | 93.4% | 1.06 | -2.75 | .. | .. | .. |
| Greece | 2.6% | 17.1% | 0.93 | -0.42 | 1.03 | 0.41 | -1.79 |
| Ireland | 2.0% | 36.7% | 1.27 | -3.57 | 1.03 | -1.40 | -3.42 |
| Italy | 17.0% | 83.6% | 0.91 | 1.38 | 1.03 | 0.57 | -0.12 |
| Luxembourg | 0.4% | 54.8% | 1.11 | -3.83 | 1.03 | -0.64 | -4.33 |
| Malta | 0.1% | 32.1% | 0.98 | -2.08 | 1.03 | 0.12 | -3.21 |
| Netherlands | 6.4% | 68.0% | 1.12 | 0.26 | 1.03 | -0.66 | -0.22 |
| Portugal | 1.9% | 61.3% | 1.07 | 0.21 | 1.03 | -0.43 | -0.47 |
| Slovakia | 0.7% | 36.1% | 1.03 | -2.48 | 1.03 | -0.18 | -3.36 |
| Slovenia | 0.4% | 73.4% | 1.02 | -0.71 | 1.03 | -0.11 | -1.64 |
| Spain | 11.8% | 44.0% | 1.16 | 0.07 | 1.03 | -0.88 | -0.22 |

* The ECB and national central banks except Germany's are assumed to internalize the government budget constraint; the Bundesbank on its own is assumed to be able to commit to IT.

Source: Author's calculations.

If the ECB were not independent, but instead internalized the weighted average budget constraints of member governments, then for some current member countries the euro zone would be worse than having their own currency, even if on their own their central banks would not be independent either. This is the result of considerable differences in financing needs as well as shock asymmetries. The countries with both low shock correlations (with the average shock for the euro zone) and disciplined fiscal policies (such as Cyprus, Ireland, Malta and Slovakia) would unambiguously do better on their own, while smaller losses are experienced by Finland, Greece and Slovakia. In the cases of Estonia and Luxembourg, both more fiscal discipline and larger shocks (it is not just the correlation that matters) explain the value of retaining the ability to design their own monetary policy rather than accepting a policy that reflects average conditions in the euro zone.

The right-most three columns in Table 6 give an approximate decomposition of the welfare gain into three components:¹¹ the result of internalizing the Barro-Gordon temptation to generate monetary stimulus by depreciation of one's own currency (no longer possible in the euro zone), the effect of fiscal asymmetries (a

11 It is not available for Germany because of the assumption that the Bundesbank targets inflation, making the decomposition not applicable.

gain for countries whose fiscal policy is laxer than the average, as indicated by a value of FN_{mu}/FN less than one), and the effect of shock asymmetries. Each of the effects is important, though the third one, which is the standard OCA criterion, dominates for several countries. Perhaps not surprisingly, the largest overall net gainers are France, Italy and Belgium.

The case of Germany is treated differently. In particular, the historical circumstances of Germany's Bundesbank, which was at the centre of the European Monetary System (EMS) and the initial source of monetary policy credibility of the euro zone, as well as the constitutional protection against monetary financing in Germany, put it in a special position. Unlike other countries' central banks, the Bundesbank is assumed not to be subject to financing pressures on the part of the German government. Therefore, we compare the welfare of Germany in a euro zone having a dependent ECB to its welfare if it had its own currency, managed by an independent IT central bank. It can be seen that under these circumstances, Germany would sustain a large gain in welfare by abandoning the euro zone and reintroducing the deutsche mark. The political and administrative costs of leaving the euro zone are not considered here, however, and these would undoubtedly influence any decision to do so. Nevertheless, the welfare calculus highlights the reason why Germany has legitimate concerns about the independence of the ECB and the desirability of maintaining the euro zone in its current form.

The next exercise considers whether the welfare of the remaining countries would be improved by expelling any of the existing members individually. Table 7 summarizes these results; the difference in welfare for the country leaving can be found in Table 6. It can be seen that the departure of Greece or Italy would improve welfare of all or almost all of the remaining euro zone countries, while France's departure would be almost as welcome. The effect of other countries' departures would generally be negative on all remaining members. Effects are small, however, since each country has only a modest influence on the ECB's policies. The hypothetical departure of Germany would induce the largest welfare losses.

The final exercise revisits the assumption of a dependent central bank for the monetary union. In particular, it could be that a narrower monetary union centred around Germany could also effectively carry out an independent monetary policy, even if the larger euro zone were unable to do so. The assumption, therefore, is that the monetary union (whether it was called the euro zone or not) would be able to commit to an IT policy, and would not be subject to pressures to finance governments.

Three small "Germanic" monetary unions are considered: a successor to the "deutsche mark zone" composed of Germany, Belgium, the Netherlands, Luxembourg and Austria (countries whose exchange rates were stable throughout the 1992-93 EMS crisis); a wider core group that includes France as well, because France played an integral part in the process of monetary integration; and a monetary union including all those countries in the current euro zone that have financing needs that are less than or equal to Germany's (see Table 5), namely Cyprus, Estonia, Finland, Germany, Ireland, Luxembourg, the Netherlands, Portugal and Spain. We compare welfare of the hypothetical member countries of these narrower monetary unions with their welfare both as members of the present euro zone (with a dependent ECB) and as countries reverting to their own currencies — that is, monetary autonomy, but without the ability to pre-commit to inflation targeting — except for Germany. As before, for Germany the comparison is with an independent Bundesbank. Table 8 summarizes the results.

Table 7: Welfare Effects on Countries in the Stub of Dropping Countries in the Heading One-by-One 1/

| Country | Austria | Belgium | Cyprus | Estonia | Finland | France | Germany | Greece | Ireland | Italy | Luxembourg | Malta | Netherlands | Portugal | Slovakia | Slovenia | Spain |
|-------------|---------|---------|--------|---------|---------|--------|---------|--------|---------|-------|------------|--------|-------------|----------|----------|----------|--------|
| Austria | | -0.199 | -0.002 | -0.003 | -0.012 | 0.005 | -0.361 | 0.011 | -0.033 | 0.037 | -0.013 | -0.001 | -0.247 | -0.029 | -0.019 | -0.010 | -0.186 |
| Belgium | -0.065 | | -0.002 | -0.003 | -0.018 | 0.027 | -0.402 | 0.014 | -0.031 | 0.045 | -0.015 | -0.001 | -0.225 | -0.026 | -0.019 | -0.012 | -0.155 |
| Cyprus | -0.074 | -0.211 | | -0.005 | -0.019 | -0.005 | -0.398 | 0.000 | -0.048 | 0.074 | -0.015 | -0.002 | -0.273 | -0.030 | -0.024 | -0.014 | -0.192 |
| Estonia | -0.060 | -0.214 | -0.003 | | -0.050 | 0.062 | -0.509 | -0.001 | -0.075 | 0.126 | -0.028 | -0.001 | -0.293 | -0.037 | -0.030 | -0.015 | -0.138 |
| Finland | -0.059 | -0.214 | -0.002 | -0.007 | | 0.082 | -0.585 | 0.020 | -0.042 | 0.069 | -0.020 | -0.002 | -0.262 | -0.034 | -0.024 | -0.020 | -0.109 |
| France | -0.057 | -0.167 | -0.002 | -0.003 | -0.012 | | -0.319 | 0.004 | -0.030 | 0.040 | -0.011 | -0.001 | -0.214 | -0.023 | -0.014 | -0.010 | -0.144 |
| Germany | -0.058 | -0.201 | -0.002 | -0.004 | -0.024 | 0.094 | | 0.021 | -0.033 | 0.060 | -0.019 | -0.001 | -0.251 | -0.029 | -0.023 | -0.015 | -0.111 |
| Greece | -0.056 | -0.170 | -0.003 | -0.004 | -0.010 | -0.013 | -0.276 | | -0.031 | 0.068 | -0.006 | -0.001 | -0.247 | -0.021 | -0.020 | -0.011 | -0.152 |
| Ireland | -0.074 | -0.231 | -0.004 | -0.008 | -0.025 | 0.049 | -0.461 | 0.015 | | 0.110 | -0.018 | -0.002 | -0.291 | -0.042 | -0.033 | -0.015 | -0.158 |
| Italy | -0.057 | -0.171 | -0.002 | -0.003 | -0.015 | 0.030 | -0.393 | 0.012 | -0.027 | | -0.014 | -0.001 | -0.212 | -0.026 | -0.015 | -0.011 | -0.123 |
| Luxembourg | -0.054 | -0.220 | -0.002 | -0.009 | -0.035 | 0.170 | -0.714 | 0.059 | -0.035 | 0.035 | | -0.001 | -0.264 | -0.039 | -0.026 | -0.014 | -0.092 |
| Malta | -0.058 | -0.192 | -0.003 | -0.001 | -0.022 | -0.025 | -0.470 | 0.041 | -0.048 | 0.095 | -0.013 | | -0.238 | -0.032 | -0.017 | -0.018 | -0.128 |
| Netherlands | -0.071 | -0.211 | -0.003 | -0.005 | -0.018 | 0.029 | -0.459 | 0.003 | -0.037 | 0.071 | -0.017 | -0.002 | | -0.034 | -0.025 | -0.013 | -0.175 |
| Portugal | -0.067 | -0.205 | -0.002 | -0.004 | -0.022 | 0.058 | -0.463 | 0.018 | -0.044 | 0.044 | -0.018 | -0.002 | -0.270 | | -0.024 | -0.014 | -0.159 |
| Slovakia | -0.060 | -0.195 | -0.003 | -0.006 | -0.024 | 0.152 | -0.553 | 0.003 | -0.058 | 0.144 | -0.018 | -0.001 | -0.276 | -0.037 | | -0.014 | -0.157 |
| Slovenia | -0.043 | -0.194 | -0.002 | -0.004 | -0.053 | 0.096 | -0.624 | 0.014 | -0.035 | 0.059 | -0.016 | -0.002 | -0.236 | -0.034 | -0.022 | | -0.068 |
| Spain | -0.082 | -0.226 | -0.003 | -0.004 | -0.013 | 0.001 | -0.404 | 0.008 | -0.038 | 0.062 | -0.015 | -0.002 | -0.288 | -0.034 | -0.024 | -0.012 | |

1/ ECB assumed to internalize government budget constraints

Source: Author's calculation. Welfare measured in percentage points of GDP.

Table 8: Welfare of "Germanic" Monetary Unions Compared to Euro Zone and Monetary Autonomy, in Percent of GDP

| Country | Gain with respect to euro zone | | | Gain with respect to autonomy | | |
|-------------|--------------------------------|-------|-------|-------------------------------|--------|--------|
| | I | II | III | I | II | III |
| Austria | 1.785 | 1.910 | | 2.625 | 2.750 | |
| Belgium | 1.581 | 1.635 | | 2.607 | 2.661 | |
| Cyprus | | | 2.557 | | | 2.652 |
| Estonia | | | 2.992 | | | 0.519 |
| Finland | | | 2.777 | | | 2.355 |
| France | | 1.107 | | | 2.605 | |
| Germany | 2.558 | 2.444 | 2.569 | -0.194 | -0.308 | -0.184 |
| Ireland | | | 3.500 | | | -0.066 |
| Luxembourg | 3.030 | 2.762 | 2.980 | -0.799 | -1.068 | -0.849 |
| Netherlands | 2.599 | 2.669 | 2.733 | 2.856 | 2.925 | 2.990 |
| Portugal | | | 2.532 | | | 2.739 |
| Spain | | | 2.854 | | | 2.928 |

Interestingly enough, all of these core monetary unions are better than the euro zone for Germany and for each of the other potential members, and the gains of welfare are sizeable, running from 1.0 to 3.5 percent of GDP. However, none of them is better than autonomy for Germany. The reason is that such a deutsche mark-based monetary union, even if it could ensure central bank independence and, hence, face no fiscal pressures on monetary policy, would still respond not to Germany's shock, but to the average of the shocks for the member countries. At the same time, there would be little advantage from internalizing the region's trade on monetary policy because of the narrowness of the region. The net effect would be a small loss for Germany in each case.

CONCLUSIONS

In summary, the basic model seems to offer considerable support for the fears that the euro zone in its current configuration is at risk should the ECB effectively become dependent on pressures to finance its member governments. The model, of course, does not perfectly capture the complexity of the current crisis in the euro zone, nor the tools at the disposal of the ECB. It could be argued, for instance, that the operations of the ECB in purchasing government bonds need not imply debt monetization and upward pressure on consumer prices, while the model assumes that ECB essentially has a single policy instrument, namely inflation. The traditional lender of last resort role for a central bank in providing liquidity to financial institutions to correct a market failure or prevent an incipient bank run need not interfere with price stability. However, the situation becomes more complicated once the ECB purchases public debt of governments that may become insolvent; if, as a result, the ECB makes losses and needs to be recapitalized, its independence may be put in jeopardy. The model does not analyze the complex strategic interactions between governments and the central bank that may result. Instead, it explores the consequences of assuming that the ECB might lose its independence and internalize member governments' budget constraints — with the objective of financing governments being weighted against other objectives in a way that is consistent with data for countries like Italy in the 1970s.

Should the ECB become a dependent central bank in that sense, the departure of several of the current members with weaker regional ties, and less disciplined fiscal policies, might well be desired by the rest of the member countries. The departure of Greece — a country with fiscal problems, little trade with the rest of the euro zone and asymmetric supply shocks — would make sense both on its own account and that of other members. The simulations reported here also suggest that two larger countries, Italy and France — both at the centre of the European monetary unification project — are also a drag on their more fiscally disciplined colleagues whose welfare would be improved by their departure.

The idea of a narrower monetary union centred around Germany, if it had the ability effectively to carry out an IT policy and resist pressures to internalize government budget constraints, would seem to be an attractive alternative for the more fiscally disciplined members. However, the simulations presented here suggest that this may not be in Germany's interest. Rather than a full monetary union, therefore, a German-led monetary bloc might have the Bundesbank simply set monetary policy on the basis of Germany's needs, and the other countries following.¹² However, this return to the *de facto* deutsche mark zone of the 1980s and 1990s would be an enormous reverse for European integration that most European politicians, as well as the general public, would find difficult to accept. Thus, the likeliest outcome of the euro zone crisis may well be only a minor change in the monetary union's composition, if any, while hopefully addressing the forces that now endanger the central bank's independence.

In particular, the euro zone's institutions need to be strengthened, first, by reinforcing fiscal discipline, and second, by increasing the ability of facilities other than the ECB to provide financial assistance. In addition, creating an area-wide financial supervisor would reinforce confidence in the stability of the banking system, lessening pressures on the ECB's lender of last resort facilities. With luck, the economic and monetary union may emerge from the current crisis strengthened, not destroyed as some have feared.

12 As is the case in the Common Monetary Area, in which the South African Reserve Bank sets monetary policy based on conditions in that country, and Lesotho, Namibia and Swaziland peg their currencies at a one-to-one parity with the rand and follow South Africa's monetary policy (Masson and Pattillo, 2005).

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