

**Cohesive Divergence? The regional implications of the economic governance of the Euro-Area**

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### **Abstract**

On the 1<sup>st</sup> January 2007, Slovenia became the thirteenth member of the Euro-Area (those EU Member States who have adopted the Euro). As the first Accession State of the European Union (EU) to do so, its entry marks a potential point in the economic governance of the single currency of the European Union. In spite of the apparent success of the Euro as an increasingly important international currency, a number of problems in the economic governance of the Euro-Area remain. The paper argues that the precepts of the Maastricht Treaty, that established the single currency, and the operation of the Growth and Stability Pact, designed to restrain excessive fiscal deficits, locks the Euro-Area regions into a monetary straitjacket. That is, the transmission of a uniform monetary policy inhibits authorities from managing asymmetric regional and sectoral shocks because of the absence of some kind of regionally-based fiscal federalism. The paper concludes by arguing that without such a system the supposed cohesiveness of a currency union that may expand to cover all EU Member States will actually generate divergence in the regions and pose difficulties for economic governance. within them.

### **Keywords**

Euro-Area; Maastricht Treaty; Growth and Stability Pact; political economy of fiscal rules; monetary and fiscal policy; managing asymmetric regional shocks; fiscal federalism; regional insurance systems;

## 1. Introduction

The European single currency, the *€uro*, came into being on 1<sup>st</sup> January 1999, accompanied by a great fanfare in Frankfurt, home of the newly created European Central Bank (ECB). To the optimists, this event represented the next stage of the renaissance of Europe as an economic powerhouse and the creation of a new global currency to challenge the hegemony of the US dollar. To the sceptics, it represented the weakening of the EU's anti-inflationary credentials as a composite currency of the then eleven Member States of the single currency area (Euro-Area) replaced the *deutschmark* as the fulcrum of a zone of monetary stability. The continual weakening of the *€uro* against world's other currencies – losing 13.5% of its value within seven months of its inception – suggested that the sceptics may have been correct about the sustainability of the monetary union, in the first instance. The subsequent rise back to its original trading levels against the dollar, yen and sterling, by mid 2003, suggest the Europhiles may won the argument, at least as far as the external sustainability of the new currency is concerned.

By late 2005, however, changes in the economic governance within the EU, following enlargement; the breaking of the conditions of the Growth and Stability Pact (GSP) (the fiscal rules underwriting the *€uro*) in a number of key Member States; and economic and political uncertainty in Italy suggested to some commentators that the *€uro* and the Euro-Area may not be sustainable over the longer term. In January 2007, Slovenia was admitted to the Euro-area: the first Accession State to do so. As other Accession States seek membership, the sustainability of the *€uro* and the robustness of its institutional foundations will come under greater scrutiny

The concern in this paper is not the sustainability of the *€uro*, *sui generis*, although this potential problem remains an important parameter in the economic governance of the European Union. It addresses, rather, the macroeconomic context of the fiscal implications of how the transmission of uniform monetary policy impacts the manifold regions of the EU: moreover, regions with different sectoral composition and path dependencies. By

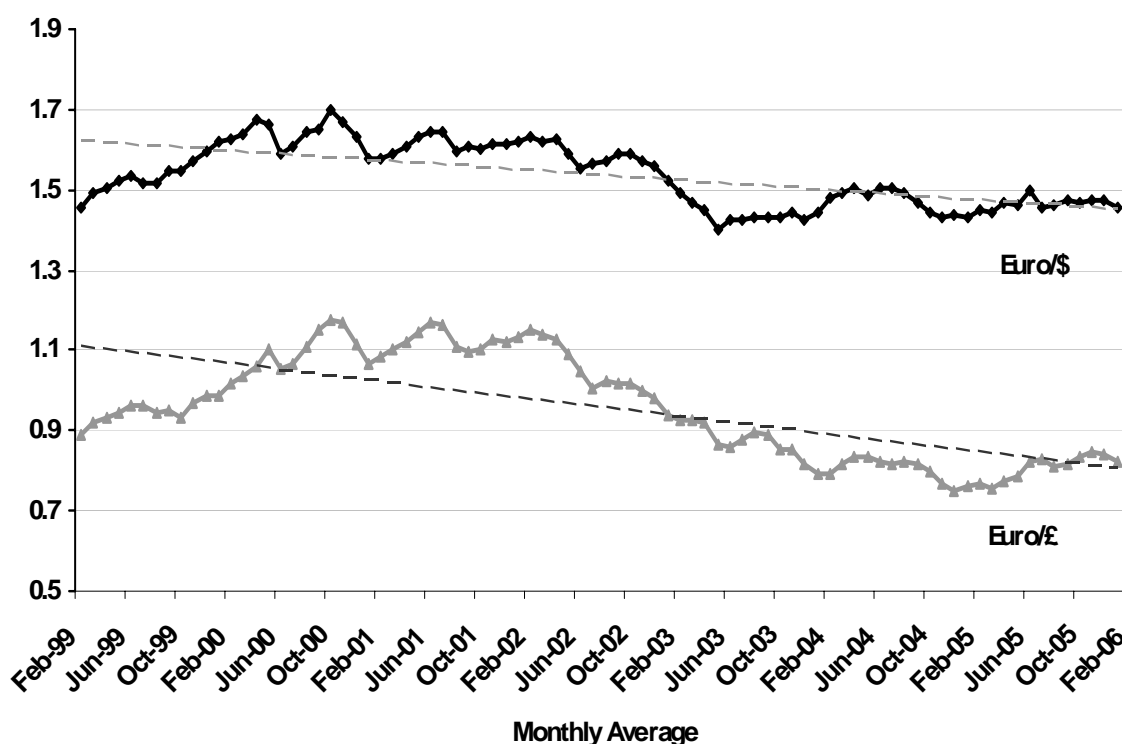
referring to various surveys and debates the paper focuses more on analysing prospects for fiscal federalism in the Euro-Area in the absence of a regional dimension to the GSP.

## 2. Background Macroeconomic Commentary

Conventionally, exchange rates are determined by the terms of trade – the ratio of exports to imports and capital flows. The exchange rate between two countries is also often effectively determined by the setting of interest rates which impact on capital flows. *Ceterus paribus*, higher interest rates will attract external flows and thus lead to an increase in the exchange rate. However, this will be counterbalanced by a consequent lowering of inflation that will change the relative prices of traded goods and services, leading to some kind of equilibrium exchange rate.

The Euro's performance against the dollar and sterling is shown in Figure 1. After the initial strengthening against the euro, both currencies have declined as shown by the trend lines in the figure.

**Figure 1: Euro/US\$ and Euro/UK£ exchange rates 01/99-02/06**

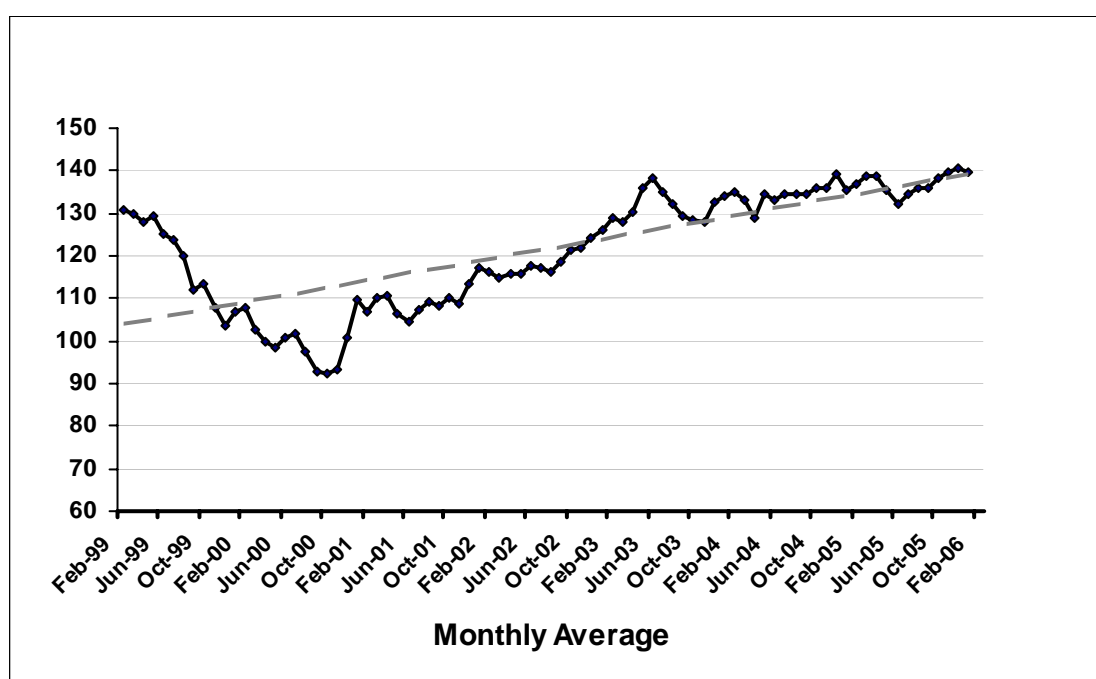


Source: PACIFIC EXCHANGE SERVICES (2006)

.A similar picture emerges in respect of the Yen as shown in Figure 2 below showing the Euro strengthening against the Yen. However, in all three cases, it is extra- Euro-Area

factors that account for the position of the €uro against these major currencies and not growth performance of Euro-Area (OECD, 2006) Firstly, the volatility of the €uro against the dollar, reflects the unbalanced nature of the US economy. Secondly, the recent deflationary nature of the Japanese economy, with negative real interest rates since the bursting of the “bubble economy” in the early 1990s, accounts for international investors being willing to hold €uro-denominated rather than Yen-denominated assets (NATIONAL INSTITUTE ECONOMIC REVIEW, 2006a).

**Figure 2: Yen/ euro monthly exchange rate (01/99 – 02/06)**



Source: PACIFIC EXCHANGE SERVICES (2006)

On average the €uro has strengthened against the major currencies since 2003. This outcome is not a result of an accelerated EU economy. Growth in the Euro-Area has remained lacklustre over the medium term in contrast to the growth of the US economy, however uneven. To a large extent, strengthening of the €uro has been triggered by a change in capital flows across the Atlantic in favour of the Euro-Area, as investors have taken a more cautious approach towards the US economy, due in part to the market perception that the US has abandoned its strong dollar policy. Investors have also worried about the US's growing twin deficits (BANK OF JAPAN, 2006). The US's current account

deficit, for instance, widened to nearly 7% of its GDP in 2005, while the current account of the Euro-Area has become positive over the last couple of years. Table 1 gives a summary of the Euro-Area12 performance in comparison to the world's other leading economies.

**Table 1; Comparative economic indicators (1999-2005)**

Measure	Economy	1999	2000	2001	2002	2003	2004	2005
<b>Real GDP<sup>1</sup></b>	EU12	2.8	3.9	1.9	1.0	0.8	1.8	1.4
	US	4.4	3.7	0.8	1.6	2.7	4.2	3.6
	Japan	-0.1	2.4	0.2	-0.3	1.4	2.7	2.4
	OECD	3.3	3.9	1.1	1.5	2.0	3.3	2.7
<b>Unemployment rate<sup>2</sup></b>	EU12	9.2	8.2	7.9	8.3	8.7	8.9	n/a
	US	4.2	4.0	4.7	5.8	6.0	5.5	n/a
	Japan	4.7	4.7	5.0	5.4	5.3	4.7	n/a
	OECD	6.6	6.2	6.4	6.9	7.1	6.9	n/a
<b>Consumer Price Index<sup>3</sup></b>	EU12	0.9	2.3	2.4	1.9	1.9	1.9	1.9
	US	1.7	2.5	2.1	1.4	1.9	2.6	2.8
	Japan	-0.5	-0.8	-1.0	-1.2	-0.7	-0.5	-0.5
	OECD	1.7	2.5	2.1	1.4	1.9	2.6	2.8
<b>Real Effective Exchange Rates<sup>4</sup></b>	EU12	109.9	100.0	102.5	106.4	119.4	123.8	121.9
	US	97.6	100.0	105.3	105.8	99.6	95.1	92.9
	Japan	91.9	100.0	92.3	88.4	91.4	95.3	92.5
	OECD	n/a	n/a	n/a	n/a	n/a	n/a	n/a
<b>Current Account Balance<sup>5</sup></b>	EU12	0.3	-0.7	0.1	0.7	0.3	0.5	-0.2
	US	-3.2	-4.2	-3.8	-4.5	-4.7	-5.7	-6.5
	Japan	2.6	2.5	2.1	2.8	3.2	3.7	3.4
	OECD	-0.7	-1.3	-1.1	-1.2	-1.1	-1.3	-1.8
<b>Government balances<sup>6</sup></b>	EU12	2.3	3.5	1.4	0.6	-0.1	0.1	-0.2
	US	3.6	4.1	1.9	-1.7	-3.1	-2.9	-1.8
	Japan	-5.8	-6.0	-4.7	-6.5	-6.3	-4.8	-4.8
	OECD	1.9	2.7	1.0	-1.1	-2.1	-1.6	-1.3

<sup>1</sup> as % change from previous year

<sup>2</sup> standardised International Labor Organization (ILO) rate

<sup>3</sup> harmonised inflation rate

<sup>4</sup> 2000 = 100 based on index of Purchasing Power Parities (PPPs)

<sup>5</sup> as % of GDP

<sup>6</sup> government balances excluding net interest payments

Source (OECD, 2006)

Comparisons of this kind are both useful and invidious in respect of the performance of the Euro-Area economies. They are helpful on the one hand in showing the trajectory of economic development of the Euro-Area12 (now Euro-Area13 following the admittance of Slovenia to the single currency on 1<sup>st</sup> January 2007) since the introduction of the €uro and against the world's other major economies. Other the other hand, the Euro-Area is not a unitary economy in the way that the others are in terms of integration of activities,

institutions of economic governance and well established transmission mechanisms of this form of monetary policy. The introduction of the €uro effectively relegates the constituent Member States to regional status in that the management of exchange rate and monetary policy is. derogated to EU-level institutions

The twin-track of the €uro's trajectory, as external reserve currency and as single currency within the EU, to complete the Single European Market (SEM) presents major challenges to the both EU and Member State policy makers. At the heart of these problems is the issue of the €uro as a potential international reserve currency and at the same time as the monetary anchor for the current Euro-Area members. The ECB is concerned with price stability along with ECOFIN (the Council of Finance Ministers in the EU) but has no explicit exchange rate policy or managing the domestic (within each Member State) general price level implications of volatile movements in the other major currencies. Member States and constituent regions exposed to greater international competition may be subject to greater asymmetric shocks, as the operation of sterilising of the monetary effects of unexpected currency movements occurs at the Euro-Area level through changes in interest rates. In the absence of other localised instruments the net effects are borne by changes in output and employment.

The possibly more important issue is the institutional failure of the ECB and members of ECOFIN to address divergence in the real economy and how to deal with asymmetric shocks across regions and sectors within the EU. Moreover, the apparent inability to integrate economic governance and its institutions in the EU poses challenges, particularly in respect of its expansion to twenty seven Member States, many of those outside the Euro-Area anchor their currencies to €uro It is already apparent that monetary policy alone cannot manage imbalances within the Euro-area, evidenced by continuing relatively high levels of unemployment and a deterioration in the external position of a number of Member States (OECD, 2006).

At the heart of the matter is the issue of the transmission of a uniform monetary policy to the existing regions of the Euro-Area. In the same way that the derogation of exchange rate management to EU institutions has relegated the Members States, who participate, to

regional status, so the sub-national regions' ability to adjust to asymmetrical shocks, whether sectoral or indigenous has been weakened. Therefore, the consequences of setting Euro-Area-wide interest rates will impact on regions differently and cut across national boundaries. In this context setting optimal interest rates is technically challenging.

A guideline to interest setting was established by John Taylor, an economist from the University of Stanford in the US. Essentially this rule proposes the setting of interest-rates that will stabilise the economy in the short term and at the same time maintain long-term growth. The *Taylor Rule* is based on three main factors:

1. The difference between actual inflation and that targeted by monetary authorities;
2. The size of the output gap in the economy represented by the difference between full employment and actual employment;
3. Setting of short-term interest that is consistent with the achievement of full employment.

In situations where inflation is above target and the output in the economy is above its full employment capacity a relatively high short-term interest should be set, leading to the tightening of monetary policy and vice versa. The rule does also recommend guidance to economic policy makers when, for example, inflation is above target but the economy is operating below full employment (TAYLOR, 1993)

The European Central Bank (ECB) operates an inflation target of 2% and sets interest rates to achieve this, consistent with the strictures of the Taylor rule. However, the interest rate is the linking mechanism between monetary and fiscal policy. Furthermore, the setting of interest rates influences financial markets and investment decisions, through its impact on the cost of capital. The problem for the Euro-area is that, unlike in unitary economies, management of monetary policy and fiscal policy is asymmetrical. To constrain the national discretion over fiscal policy: a set of rules is laid out in the Maastricht Treaty and the Growth and Stability Pact (GSP). Ruled-based fiscal policy is consistent with what BEGG and SCHELKLE call the 'new political economy of fiscal rules' (BEGG and SCHELKLE 2004). That is, the imposition of rules to constrain political

institutions from engaging in fiscal profligacy that may be pro-cyclical. This rule-based feature of the operation of fiscal policy appears to be consistent with a Taylor-like approach, but what is the appropriate Taylor rate for the Euro-area that contains thirteen economies of different sizes and structures, output gaps and inflationary tendencies?

In the absence of a euro-zone fiscal authority (equivalent to the ECB), however, a number of difficulties arise. These include the operation of automatic stabilisers and implementation lags in the operation of fiscal policy in each Member State (BAYOUMI AND MASSON, 1998). For the real economy, other problems arise. For example, interest rates that may be appropriate to the cost of capital in Baden-Wurtemberg and Emilia-Romagna may not be appropriate in Nord-Pas-Calais and Mecklenburg. At the same time, in Members States that lack systems of fiscal decentralisation, including local and regional government bond markets, there will be more constraints on using fiscal policy to deal with regional shocks and adjustment.

The continuing impasse in solving the asymmetrical nature of economic governance in the Euro-Area is summed up in the following quote.

There is an alarming knowledge gap regarding developments at disaggregated levels, given the difficult and ongoing process of harmonisation of statistics in Europe. Individual governments should be concerned, as the automatic adjustment mechanisms of labour and product markets are clearly being tested earlier and more severely than had initially been anticipated (BJÖKSTÉN and SYRJÄNEN, 1999).

This comment, from two economists at the Bank of Finland a number of years ago, suggests that even within the central banking community, the design of the Maastricht criteria, and the subsequent Growth and Stability Pact, may have been flawed from the outset. Perhaps more importantly, the failure to initiate more comprehensive policy institutions, to manage real sectoral and regional differences, makes the expansion of the EU more difficult and potentially more volatile than is necessary. The inability to date of the EU to integrate its different forms of economic governance with that of the successful operation and management of €uro does threaten the coherence of the EU as an

economic entity and the full development of the SEM. Furthermore, this failure potentially relegates regional policy to a role concerned with infra-marginal change rather than being a central element in managing the *New Europe* or progress towards a *Europe of the Regions*.

In the literature, there has been little that is explicit on the regional implications of fiscal policy in the EU (with the exception of BUDD, 1997, HALLETT, 1998, KOUPARITAS 1999, OBSFELD and PERI, 1998 BEGG and HODSON 2000), and rather more emphasis of regional aspects of European and Monetary Union (EMU) in general (ARNOLD, 1999, BUDD 2000, MARTIN, 2001, HAWKINS, 2002). SHEILA DOW and CARLOS RODRÍGUEZ-FUENTES' two interventions on a uniform monetary policy and the problems of regional transmission are excellent exemplars of the implications debate but hers focuses almost solely on monetary policy *sui generis*, (DOW and RODRÍGUEZ-FUENTES, 1997, RODRÍGUEZ FUENTES and DOW, 2003).

The next section of the paper surveys some of the debates and literature surrounding these issues.

### **3. Surveying the macroeconomic context for regional events**

As one of the core elements of economic governance of the EU, the management of the Euro can appear to be somewhat distant from the development and performance of the real economies of the Member States, particularly sectors and constituent regions. At the heart of the Euro-Area management system is the Maastricht Treaty rules whose implementation and operation are buttressed by GSP. The fiscal rules of Maastricht are:

1. a ceiling for the budget deficit of 3% of Gross Domestic Product (GDP)
2. a maximum of total debt to GDP ratio of 60%;
3. That budget balance should be achieved over the economic cycle;

One of the most virulent critics of the "Maastricht numerology" is the economist Willem Buiter who claims that they represent "economic nonsense" (BUITER, 1993). This claim appears to have borne out by events since the inception of the Euro. Although the Euro has established its credentials as a favoured denominated currency for financial asset classes in many but not all parts of the world, the imposition of a one-size fits all monetary

policy for the Euro-Area economies has caused difficulties for the management of economic policy and economic governance in general in a number of Member States, notably the Big Three of Germany, France and Italy (for detailed discussion see von HAGEN, 2006, NATIONAL INSTITUTE ECONOMIC REVIEW 2006b)

The underlying rationale for policy convergence being the fulcrum of real economic convergence was “credibility theory” rather than that of the theory of optimal currency areas<sup>1</sup>. That is, achieving the convergence of fiscal and monetary targets by means of macroeconomic policy imperatives will be deemed credible by economic actors, in particular international financial markets, and as such generate a process of real economic convergence. (See BUITER *op.cit*, ANGELONI AND DEDOLA 1999, FITOUSSI and SARACENO, 2002 for detailed arguments)

One way of assessing the credibility perspective is to view the economic governance of a single currency area becomes a kind of club good. That is, the credibility of policy makers’ inflation targeting and avoiding excessive government deficits (and the monetary consequences of them) generates positive externalities for all members of the “club”, despite different credibility capabilities of individual Member States (see KÖLLIKER, 2001 for fuller discussion.) The major characteristic of a club good is that is excludable but non-rival in consumption, so that insiders share the collective benefits, whilst outsiders are unable to enjoy them. Club goods are subject to “congestion” as more and more members join the club a threshold is reached beyond which consumption becomes rival and decreasing utility sets in. In the case of the EU as a whole the size of the club expands with membership, although the relationship can appear asymptotic, it is apparent that there is a size threshold at which congestion sets. The more stringent rules and also capabilities needed for membership of the Euro-Area appears to make its congestion threshold much smaller.

Some of the literature investigates the proposition that the Euro-Area represents strong aspects of an ‘excludable network good’. That is, a good that is subject to excludability but consumption of it tends to be complementary. This approach argues that its utility grows with the number of participants. Non-participants are effectively excluded from its positive

effects. This perspective is one that putative members of an expanding EU find beneficial to their arguments in favour of joining the Euro-Area because the costs of joining and administering the Euro-area are shared. The other argument is that joining the Euro-Area generates efficiency gains and growth from greater competition and lower transactions costs of a single currency area (GABEL, 1999). The competition argument seems to apply more to the SEM, rather than the Euro-area. It also can be argued that the congestion threshold of the SEM is much larger than that of the Euro-area, given recently difficulty in fulfilling the conditions of the GSP in a number of Member States. If the Euro-area is to be considered as an excludable network good and not a club good, then the characteristics of the Euro-Area would seem to have to include some system of fiscal federalism. This assertion rests on the argument that the application of a symmetrical monetary policy to the asymmetry of regional and sectoral shocks in the real economies of fifteen Member States with distinct capacities and capabilities will reinforce the club good nature of the Euro-Area and create a lower threshold of congestion as Accession Member States seek membership.

The fiscal rules of the Euro-area are embodied in the Growth and Stability Pact (GSP), designed to avert excessive deficits in the Euro-Area and control any spillover effects. The application of the GSP tends to reinforce the argument made above. In this policy environment, it is argued that “a one size fits all” monetary policy of single interest setting in the Euro-Area by the ECB will be sufficiently optimal to compensate for real regional and sectoral imbalances between Member States. The evidence for convergence between 1992 and 1997 suggests that the policy stance of the EU and its post-1999 agent, the ECB, was sufficiently credible to induce greater economic convergence. Since the Euro’s introduction there has been greater divergence in inflation and unemployment rates as shown in Table 2 below . The interesting question is the degree to which the establishment of the Euro-Area lowered the Non-Accelerating Rate of Unemployment (NAIRU), commonly known as the “natural rate”. In fact it has remained stubbornly high at around 8% since the early 1980s (McADAM and McMORROW,1999). Debates about the

**Table 2: Inflation and Unemployment rates (2000-2005)**

	<b>2000 (p)</b>	<b>2000 (u)</b>	<b>2001 (p)</b>	<b>2001 (u)</b>	<b>2002 (p)</b>	<b>2002 (u)</b>	<b>2003 (p)</b>	<b>2003 (u)</b>	<b>2004 (p)</b>	<b>2004 (u)</b>	<b>2005 (p)</b>	<b>2005 (u)</b>
<b>Austria</b>	2.0	3.6	2.3	3.6	1.9	4.2	1.3	4.3	1.9	4.1	2.1	4.2
<b>Belgium</b>	2.6	6.9	2.3	6.6	1.6	6.9	1.3	7.1	1.9	6.8	2.5	8.4
<b>Finland</b>	3.0	9.0	2.6	9.1	2.2	9.1	1.3	9.0	0.1	9.0	0.8	9.0
<b>France</b>	2.1	9.3	2.4	8.5	1.5	8.9	2.2	8.9	2.3	8.9	1.9	9.3
<b>Germany</b>	2.1	7.8	2.4	7.8	1.5	8.2	1.0	8.1	1.8	8.8	1.9	8.4
<b>Greece</b>	2.9	11.1	3.7	10.5	3.9	10.1	3.4	10.2	3.0	10.1	3.5	8.1
<b>Ireland</b>	5.2	4.2	4.0	3.8	4.1	4.5	4.0	5.1	2.3	5.4	2.2	4.3
<b>Italy</b>	2.6	10.4	2.4	9.4	2.4	9.0	2.8	9.0	2.3	8.8	2.2	8.1
<b>Netherlands</b>	2.4	2.8	5.1	2.4	3.9	2.8	2.2	3.2	1.4	5.0	1.5	5.7
<b>Portugal</b>	2.8	4.1	4.4	4.1	3.6	4.5	3.3	5.0	2.5	4.8	2.1	6.6
<b>Spain</b>	3.5	11.3	2.8	10.7	3.4	11.3	3.1	11.2	3.1	11.0	3.4	10.9
<b>Euro-Area12</b>	2.4	8.4	2.5	8.0	2.3	8.3	2.1	8.3	2.1	8.2	2.2	8.9
<b>EU15</b>	2.1	7.8	2.3	7.4	2.1	7.6	2.0	7.6	2.0	7.6	2.1	8.1
<b>EU25</b>	2.4	8.6	2.5	8.4	2.2	8.8	1.9	9.0	2.1	9.1	2.2	8.7
<b>US</b>	2.5	4.0	2.0	4.8	1.4	5.8	1.8	6.0	2.4	5.6	2.5	5.5
<b>Japan</b>	-1.2	4.7	-1.6	5.0	-1.3	5.4	-1.4	5.3	-0.5	4.7	0.6	4.4

Source: NATIONAL INSTITUTE ECONOMIC REVIEW (2006b), EUROSTAT (2006)

European Monetary System (EMS), the forerunner of the EMS centred on the degree to which a common monetary regime would generate lower inflation and lower unemployment. Two countries outside the EMS, the UK and Switzerland, were shown to have achieved a superior performance to EMS members in lowering the natural rate of unemployment (GOLDMAN SACHS, 1988). In these circumstances, it is suggestive that a uniform monetary regime that is incapable of lowering the natural rate is one which in exogenous regional and sectoral shocks may not be managed efficaciously.

On the other hand, one explanation to support greater convergence is that the peripheral economies have benefited from price stability and the perception they are less susceptible to external shocks, inducing greater investment and consumption. (BJÖRKSTÉN AND SYRJÄNERN, op.cit). In other words, the prospect of Euro-area entry has generated one-off convergence benefits. The evidence from the post-1997 period appears to reinforce the “one off benefits” explanation. Therefore, it makes the ECB’s over-reliance on a monetary transmission mechanism to achieve real economic convergence seems irrational in a declining growth environment. In a speech given by the former President of the ECB, Wim Duisenberg, he re-iterated the ECB’s mantra that the primary objective of the ECB was price stability, to be achieved by means of its one instrument – short-term official interest rates.

It is also necessary for fiscal policy to play its part. The Stability and Growth Pact is sometimes seen as constraining the role of fiscal authorities, but this is a misconception. The Pact is required in order to ensure that *responsible* (my emphasis) fiscal policies are pursued by all participating Member States. In the longer term, an unbalanced fiscal policy has a negative effect on economic efficiency and on price developments (EUROPEAN CENTRAL BANK, 1999; 4).

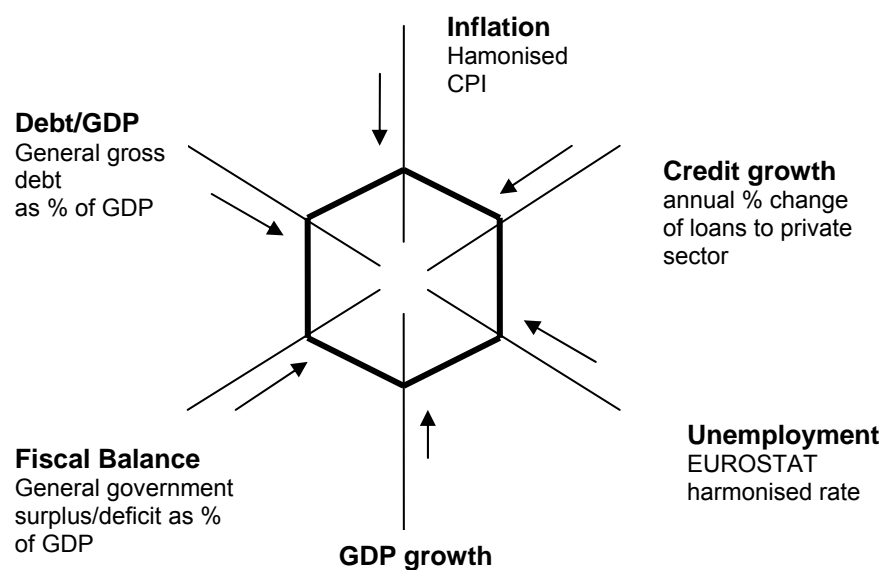
The Stability and Growth Pact is returned to below. What is clear from Duisenberg’s remarks is that the financial and political orthodoxy underlying the Maastricht Treaty ascribes an inflationary impulse to the use fiscal policy as a stabilisation instrument and the problem of public expenditure. Even within its own terms of reference, the ECB’s management of monetary policy has left a lot to be desired since the launch of the Euro

as successive Member States have sought to avoid fully complying with their obligations under GSP.

The ECB has contributed to economic imbalances because of the absolute determination by policy makers to subordinate fiscal policy to monetary policy in nearly all circumstances. Consistent and well-anticipated monetary policy as the *sine qua non* of economic convergence in a monetary union by means of market adjustment, assumes that market adjustment of itself is an optimal process. The ECB has been fortunate in inheriting the EU's monetary mantle during a significant deflationary period and a relatively stable international economic environment, mainly driven from the US and the emerging economies in Asia and Latin America.

A possibly appropriate methodology, for examining convergence and its regional implications is the "convergence barometer" has been developed by the Bank of Finland. A graphic representation is given in Figure 3 below.

**Figure 3: Converge barometer for the Euro-Area**



Source: BJOKSTEN AND SYRJÄNEN, (1999)

The direction of the arrows represents more advantageous deviations from the Euro-Area average. In order to take account of differences in the economic capacity and performance of Euro-Area *members*, weights are assigned to each of the variables in order to generate the weighted average. As a result, the shape of the hexagon changes and

**Table 3: Deviations from Euro-Area convergence criteria (1999)**

<b>Country</b>	<b>Inflation</b>	<b>Credit growth</b>	<b>Unemployment</b>	<b>GDP growth</b>	<b>Fiscal balance</b>	<b>Debt/GDP</b>
<b>Austria</b>	Above average convergence	Average convergence	Above average convergence	Average convergence	Average convergence	Slightly average convergence
<b>Belgium</b>	Slightly above average convergence	Average convergence	Average convergence	Average convergence	Average convergence	Above average divergence
<b>Finland</b>	Slightly above average divergence	Average convergence	Average convergence	Slightly above average convergence	Significantly above average convergence	Above average convergence
<b>France</b>	Above average convergence	Average convergence	Average convergence	Average convergence	Average convergence	Slightly above average convergence
<b>Germany</b>	Slightly above average convergence	Average convergence	Average convergence	Average convergence	Average convergence	Average convergence
<b>Ireland</b>	Above average divergence	Significantly above average divergence	Above average convergence	Significantly above average convergence	Significantly above average convergence	Above average convergence
<b>Italy</b>	Slightly above average divergence	Average convergence	Average convergence	Average convergence	Average convergence	Above average divergence
<b>Luxembourg</b>	Significantly above average convergence	Significantly above average divergence	Significantly above average convergence	Above average convergence	Above average convergence	Significantly above average convergence
<b>Netherlands</b>	Above average divergence	Slightly above average divergence	Significantly above average convergence	Average convergence	Average convergence	Average convergence
<b>Portugal</b>	Above average divergence	Above average divergence	Above average convergence	Average convergence	Average convergence	Slightly above average convergence
<b>Spain</b>	Above average divergence	Slightly above average divergence	Above average divergence	Slightly above average convergence	Average convergence	Average convergence

Source: Source: BJOKSTEN AND SYRJÄNEN, (1999)

distorts slightly. This occurs as a result of changes in members' performance, measured against the six variables. The results for the various economies make for interesting reading, as shown in Table 3 above:

Countries with high unemployment also tend to have high gross debt to GDP ratios and/or weak fiscal balances. These countries' scope for using fiscal policy, in order to ameliorate structural shocks to employment at national and regional levels are limited by the Maastricht criteria and the conditions of the Growth and Stability Pact. The other issue of note is the variance between Member States for each of the convergence variables. The performance of the Euro, to date, does not inspire confidence that a zone of monetary stability has been established that of itself will reduce regional divergence.

Data for 2005, corresponding to the convergence barometer is given in Table 3 below. Credit growth tends to be positively correlated to inflation via lagged monetary effects. But looking at the qualitative evidence for 1999 and the quantitative evidence for 2005, there appears to be little correlation between inflation and fiscal balance.

**Table 4: Euro convergence barometer data 2005**

Country	Inflation (%)	Credit growth (%)	Unemployment rate (%)	GDP growth (%)	Fiscal balance (of GDP %)	Total Debt/GDP (%)
<b>Austria</b>	2.0	10.3	5.2	1.9	-1.8	60
<b>Belgium</b>	2.4	15.3	8.4	1.5	-0.5	97
<b>Finland</b>	1.6	11.6	8.4	2.1	1.1	46
<b>France</b>	1.3	6.3	9.6	1.4	-2.9	69
<b>Germany</b>	0.5	1.7	9.1	0.9	-3.3	64
<b>Greece</b>	3.2	9.9	9.9	3.7	-4.6	100
<b>Ireland</b>	3.1	30.6	4.3	4.7	0.3	32
<b>Italy</b>	2.1	8.1	8.1	0.1	-4.1	107
<b>Luxembourg</b>	2.5	6.8	4.2	4.3	-2.3	6.4
<b>Netherlands</b>	1.6	-8.5	4.9	1.1	-0.6	49
<b>Portugal</b>	2.7	5.1	7.6	0.3	-2.4	59
<b>Spain</b>	4.4	23.9	9.2	3.4	0.1	62
<b>Euro-Area average</b>	1.7	6.7	8.6	1.3	-2.3	72

Source: (IMF 2006, OECD 2006, , EUROSTAT, 2006)

The weakness of the design of the Euro-Area is that it rest on credibility theory, whilst having the objective of bringing about an OCA (see BUITER op.cit, SCHELKE, 2006). The system is further weakened by the credibility problem of the ECB itself. The ECB has the single objective of price stability. It has one instrument: short-term interest rates. It has

consistently signalled to the international financial markets that it will raise short-term rates at any hint of inflationary pressures, consistent with the Taylor Rule, almost irrespective of the state of the real and complex Euro-Area economy and its regions. The convergence barometer is giving different weather reports for the different economies... In the much of the earlier part of this century, the impact of monetary tightening on growth and employment weakened the Euro, thereby weakening monetary policy, unless the monetary effects of a depreciating currency were sterilised by the ECB. Sustaining and increasing high real interest rates, to maintain a rigid 2% inflation target, has stifled growth and employment. One seasoned observer of the ECB, CHARLES WYPLOSZ, summed up this paradox:

The Fed has never come up with a tight box for inflation, so it can take a little bit of a risk. If we had 3% inflation in the euro-zone, all the media, and especially the German media, would say the ECB cannot control inflation, and we are heading for hyper-inflation. The ECB is boxed in with a monetary strategy that is a lot of nonsense, but cannot get rid of it (WYPLOSZ, 2000).

In order for the Euro-Area to be considered an optimal currency area, a system of fiscal equalisation would need to be introduced. In doing so, a greater degree of regional integration can be anticipated and the overall potential of the real economy enhanced. Yet, the commitment to fiscal restraint and rigidities inhibits this prospect. Fiscal equalisation implies re-distributing tax revenues and public expenditure to achieve balance in the economic capacities of Member States and their regions, taking account of different structures, institutions, path dependencies and the depth of “institutional embeddedness” (AMIN AND THRIFT, 1995, MARTIN AND SUNLEY, 2006 ). Rules for fiscal discipline are uniform and ignore degrees of regional difference and specialisation. In being universally applied, they are likely to exacerbate any asymmetric shocks among particular regions and sectors as one distinguished economist has noted:

Research on regional disparities across Europe shows that what happens to regional differences in living standards and unemployment depends largely on

what happens to the relative performance of individual countries. In other words, movements in regional convergence/divergence have much more to do with what is happening to growth performance *between* countries than what is happening to regional performance *within* countries. If the interest rate and the exchange rate are no longer available to address country-specific shocks, regional disparities across Europe as a whole will automatically widen. Shocks to countries also have asymmetric effects on regions. The poorer the country, the greater the asymmetric shock to regions is likely to be because labour migration cannot be regarded as an automatic safety valve for regions and countries of high unemployment (THIRLWALL, 2003, 6).

Thirlwall's intervention concentrates on regional implications, whereas other accounts often concentrate on regional aspects, a subtle but important distinction in these debates

#### **4. Fiscal Federalism and regional adjustment?**

Central to the debates and accompanying literature about the viability of monetary unions, as OCAs, is the need for adequate fiscal tools to compensate for relative immobility of factors of production (MUNDELL op.cit). These tools are essential if adjustment is to be made for asymmetric shocks. For example, the Asian crisis of 1997 created excess capacity in the automobile industry. The sudden drop in global demand fed back into the demand and supply characteristics of the industry in the EU and as a consequence impacted on the economic performance of the regions in which in which this industry operates. Clearly, within the Euro-area the effects of this kind shock will not be regionally symmetrical.

The establishment of the €uro has changed the way in which shocks are managed. There has been a shift from managing asymmetric shocks to the asymmetric transmission of uniform monetary policy shocks. A one-size fit all policy stance will be transmitted asymmetrically to the different Member States. The ECB should be more alive to the varying consequences of its monetary policy in these different Member States and their regions. This is particularly the case in respect of the expansion of the EU. Most of the evidence suggests that greater integration will reduce the regional effects of the

transmission of monetary policy in a monetary union, whereas greater industrial specialisation will increase these effects (ARNOLD OP.CIT, KRUGMAN, 1993). As the EU expands and different regions within Member States become alive to the possibilities of international growth in the major emerging economies, for example Brazil, China and India then the latter factor would seem more likely to dominate. This also reinforces demands for a consideration of fiscal federalism to “balance” the Euro-Area economy (DOGONOWSKI,1998).

Fiscal Federalism is a system of governmental transfers that enable sub-national governmental authorities to manage the impact of the business cycle and external shocks on their localised economies. There tends to be are two aspects to fiscal federalism that correspond to two components of MUSGRAVE and MUSGRAVE’S *Theory of the Multiple Household*: stabilisation and distribution (MUSGRAVE and MUSGRAVE, 1959). Writing in 1965, in respect of European economic integration, RICHARD MUSGRAVE noted:

Across the Atlantic, fiscal thinking in multi-unit terms has been stimulated by the movement for European economic integration. There the problem is one of rearranging and synchronizing the tax structure of associated countries so that economic frontiers can be eliminated and efficiency gains from tax reduction can be realized without being offset by distorting tax differentials. This problem raises the issue of tax shifting in an open economy, and thus the tools of fiscal and trade analysis are brought together. Similarly, there arise the questions of how stabilization may be made to work in an open economy, and how the interests of domestic and balance of payments stability may be reconciled (MUSGRAVE, 1965: 2)

Notwithstanding the development of the Euro, forty years on this is a key problem for the economic governance of the EU. This institutional basis for promoting fiscal federalism is reinforced by good theoretical work (MUSGRAVE, op.cit). The combination of the theory of social wants, whereby the market cannot satisfy or distribute certain wants optimally over space and that individual preference may differ between areas means that forms of fiscal federalism can contribute to efficient outcomes to the distribution of social goods.

The efficient provision of these goods thereby contributes to the competences of a region and relates to depth of its institutional embeddedness. It can be argued that both factors can operate as regional stabilisers in dealing with asymmetric shocks.

The distributional outcomes of fiscal federalism are one aspect, the other concerns stabilisation, which in turn is related to the insurance component of regional systems that represent fiscal federalism in operation. The regional aspects of stabilisation policy are the ones that directly relates to the regional implications of the euro. Within this kind of framework, the emphasis is on that nation as a network of related regions rather than a unitary market. In particular, it concentrates on the extent and causes of regional variations in cyclical patterns, particularly of unemployment.

#### *Fiscal Federalism and Regional Fiscal Equalisation Systems*

A regional fiscal equalisation system essentially consists of two components, an insurance one and a re-distributive one. The former acts to insure against the effects of temporary external shocks. The latter seeks to offset permanent regional income disparities and act as an internal re-distributive device (VON HAGEN 1992). This distinction has been generally accepted in studies of regional insurance system, undertaken in the 1990s. Most of the evidence on the differential impact of a federal insurance system is drawn from the United States and Canada (MACDOUGALL et al 1977, SALA-I-MARTIN and SACHS 1991). This evidence confirms that there is significant fiscal insurance against asymmetric shocks in the US although there is some disagreement about the size of this (see von HAGEN and HAMMOND, 1998). The evidence also suggests that the insurance is of a smaller magnitude than the income re-distributive effect. The rudiments of three systems of fiscal federalism are set out in Table 4 below. These systems are often used as comparative cases for establishing an EU-wide system and were central to the MacDougall report that investigated EEC budgetary reform. The crucial issue to be resolved is that there is no clear-cut evidence about the importance of federal insurance in federal compared to unitary states. However, in the case of the German system, there is a high degree of inter-regional and regional-federal negotiation and the relative shares of different tax revenues has changed over time

Details of three systems of fiscal federalism that influence thinking within in the EU are given in Table 4 below. As can be seen from their various strengths and weaknesses, there is not a straightforward match to the European situation. The US and Canadian systems, however, are the ones that the Macdougall Report reported on being more favourable to the EU context.

One of the challenges facing policy makers is the degree to which the inclusion of a system of fiscal federalism to manage regional shocks will enable the Euro-area to develop from a club good into an excludable network good. Following the arguments above, one can see that fiscal federalism can also been seen as a club good. However, the adoption of a system of fiscal federalism on a regional basis would seem to contribute to the Euro-area becoming an excludable network good and thus pushing back the limits of congestion. It is clear that this speculation needs further investigation and justification but one that is worthy of brief consideration in a critical survey. This appears to be pertinent in the light of the GSP and its limitation, some of which is commented on below.

#### *GSP as Fiscal Federalism?*

A number of commentators have reviewed that the case for Euro-area system of fiscal federalism at the regional scale is ambiguous (FATAS, 1998, KLETZER AND VON HAGEN, 2000). Moreover they have suggested that the fiscal discipline imposed by the GSP, in combination with EU cohesion programmes and other transfer payments form the EU to Member States undermines the case of a regional fiscal equalisation system. At the heart of this claim is that asymmetric shocks are necessarily transitory so that elaborate sub-national systems of transfers may produce distortions and perverse incentives for participating regions (EUROPEAN COMMISSION, 1997). Others may take a more critical perspective and suggested reforms to the GSP and fiscal co-ordination in the EU more generally (BEGG and SCHELKLE, op.cit, BEGG, HODSON and MAHER, 2003).

**Table 4: Systems of Fiscal Federalism**

<b>Country</b>	<b>System Basics</b>	<b>Strengths</b>	<b>Weaknesses</b>	<b>Euro-area applicability</b>
US	No formal system but a number of federal-state conditional transfers and fiscal equalisation between state and local levels. As such represents a <i>de facto</i> system	Seeks to distribute resources to achieve standardisation at appropriate levels of government	State-based system taxes and grants subject to political changes and no incentive to create efficient taxes and grants.	Yes but disputes over the relative contribution of insurance and re-distributive elements of system
Canada	Elaborate horizontal fiscal equalisation system. Objective is to equalise the tax capacity of the poorest provinces. Block grant covering health and social programmes re-distributed from federal to provincial level to ensure a national standard.	Constitutionally based system that attempts to standardise resources within a complex and geographically large federation	Asymmetric treatment of provinces with three not receiving equalisation payments and unequal compensation in the others. The problem of the taxation of natural resources which are taxed at provincial levels. Taxed away at 100% equalisation so that there is an incentive for resource-rich provinces to under-price tax contributions to federal system and/or not exploit new resources	Yes and low level of vertical fiscal insurance may accord with lack of commitment to higher EU budget and transfers from core to periphery. Lack of needs element may make system open to constant negotiation in Brussels over differing needs in EU regions
Germany	Revenue sharing from different forms of taxation between national and sub-national governmental jurisdictions	Constitutionally based system with stronger redistributive element than insurance element. High degree of transparency and accountability	Little impact on reducing GDP per capita variations and scale of re-distribution insufficient to close the absolute regional gap because of limits of on re-distribution thresholds. Disincentive built in to different regions to performance above economic trend Federal Constitutional Court	Yes but weaknesses of system and limited impact on asymmetric shocks, suggests that Euro-area and possible EU-wide would be sub-optimal. The difficulties posed by unification also suggest that new EU Member States wishing to joining the Euro-Area may experience distortions if this system was applied

Source: von HAGEN and HAMMOND (1998), MACLEAN (2003) MILWAY, (2005) RATTSSØ (2003)

The Stability and Growth Pact was introduced as part of the third stage of EMU in January 1999. It was drawn up to buttress the Euro membership conditions of the Maastricht Treaty, in particular the avoidance of “excessive” fiscal deficits. The rationale for the Stability and Growth Pact stems from the same orthodoxy analysed in the first section above. . In reviewing the debates about the GSP, FITOUSSI and SARACENO comment

The paper reviews the argument in favour and against the “Growth and Stability Pact”. We find the theoretical debate to be inconclusive, both as externality and credibility arguments can be reversed to yield opposite and, and equally plausible conclusions. (FITOUSSI and SARCENO 2002; 1)

Elsewhere, it has been cited as part of the “new monetarism” (ARESTIS AND SAWYER, 1998). The essential precepts of the “new monetarism” are not significantly different from that of “voodoo economics”. These precepts can be summarised as:

- Different time horizons of politicians and central banks due to perceptual differences concerning economic and political imperatives
- Inflation can only be controlled by monetary policy; because at all times and in all places it is a monetary phenomenon;
- The level of unemployment determined by a supply side equilibrium: the “ natural rate”, NAIRU (the non-accelerating rate of unemployment) and not by productive capacity nor aggregate demand;

Fiscal policy is subordinate to monetary policy because it has no effect on real variables, such as output, employment etc. (ARESTIS, MCCAULEY and SAWYER, 1999):

The EU has added the institutional dimension of separating monetary policy, operated independently at an EU-wide level, and fiscal policy remaining in the hands of national authorities. The deflationary bias written into the Maastricht Treaty and the Stability and Growth Pact prohibits any fiscal activism to ameliorate regional imbalances and inhibits the Euro-Area becoming an OCA: the *sine qua non* of a currency union. What is apparent is the lack of institutional harmonisation between the conduct of EU macroeconomic policy, undertaken at the level of the ECB and ECOFIN and that of other EC agencies concerned with regional development, harmonisation and evaluation. The separation of

monetary and fiscal policy creates a further cleavage between the real and nominal economy. Furthermore, the weakness of the one club approach to economic policy is underlined by institutional differences among the capital markets and financial institutions of the Member States. Moreover, short-term interest rates can only affect the level of aggregate demand and not the structure of demand and its regional components. Aside from the recent initiative of national stability plans to ameliorate the distributional effects of the Growth and Stability Pact, the essential issues remain the sectoral and regional externalities that arise from the asymmetric transmission of uniform monetary policy.

Some of the tension between the institutions of economic governance can be divined from the website of the EC's Economic and Financial Affairs (EC 2002) Under the heading of "Activities" and the sub-heading: "*The contribution of public finances to growth and employment : improving quality and sustainability*" one finds the following statement:

"The impact of public finances on the real economy is multiple and complex. Nonetheless, there is broad agreement on three main channels through which public finances can enhance potential growth and employment, as follows:

1. The accumulation of productive factors.

Governments contribute directly to growth and employment by enhancing factor accumulation. Providing the right incentives through tax and benefit systems. By influencing people's and businesses' decisions on work, saving and investment, tax and benefit systems affect the functioning of the real economy. Welfare systems play an important role in correcting market failures and ensuring social cohesion, and, via these channels contribute to growth and employment

2. Providing a stable macroeconomic climate.

Sound public finances contribute to macroeconomic stability and support monetary policy in maintaining stable prices at low interest rates. Both effects are conducive to private investment and saving.

3. Sound public finances, by reducing public debt and consequently the interest burden, creates room for a reduction in distortionary taxes and/or an increase in productive public spending". (ibid).

Although the Commission adds caveats concerning crowding out of private investment by excess public expenditure and the nod in the ideological direction of sound public finances, the admission of the role of public expenditure in generating productive potential is to be welcomed. It also shows the need for greater horizontal and vertical integration of economic institutional governance as well as regard to the management of distributional issues at the regional level.

. There may be a number of reforms of the GSP at the national level where Member States have sought to ameliorate the effects of the imposition of the GSP within their territories. These reforms, notwithstanding, there is asymmetric bias in the system in which there is a strong monetary centre (the Euro-Area) and a weak fiscal centre for which the GSP substitutes. Until there is some co-ordinating fiscal body at the EU-level rather than a set of disciplinary rules, which Member States may be temporarily in breach of from time to time, then policy co-ordination at all territorial levels remains difficult. The essential issue remains of how regional and sectoral shocks may be managed within some form of fiscal federalism. This issue is highlighted by two economists writing for the Federal Reserve in the US:

In principle one can think of several potential natural adjustment mechanisms for differential shocks. Relative prices can change, factors of production can migrate, there can be monetary transfers between regions, or fiscal policies can be different. In the EU, most of the natural adjustment mechanisms seem to be unimportant: relative prices are sluggish, labor mobility is limited, and regional transfers are minimal. This leaves differential fiscal policy as the main means of adjusting for differential shocks. The small size of the EU budget implies, at least for now, that differential EU fiscal policy will not play a large role in fiscal stabilization. Since national governments will control their much larger budgets, they could in principle act differentially: Those countries with excess demand

pressure could tighten fiscal policy and those countries with deficient demand could ease. There is no constitutional bar to such an assumption of stabilizing fiscal policy responsibilities by the component national governments. (GRAMLICH and WOOD, 2000; 15)

### **Concluding Remarks**

The fanfare accompanying the launch of the Euro no longer strikes the right key. The lamentable performance of the *Euro* in 2000, suggests that its pretence to world currency status was misplaced. The revival in its value had more to do with Extra-Euro-Area factors associated with from the imbalanced dynamics of the US economy and their impact on the dollar. The *Euro* can be said to be a success in many instances in that a very ambitious project have come to fruition and survived some eight, and at times bumpy, years. Apart from Germany's recent improvement, the relatively poor performance of the Euro-area economies suggest that the *Euro's* putative world currency status is not feeding through into significant increases in real output and employment and in the distribution of these gains across the Euro-Area's regions. The challenge of the rest of the Accession States joining the Euro-Area is yet to come.

The conceptual foundations of the Euro-Area tend to underpin the pursuit of orthodox economic governance (sometimes known pejoratively as 'voodoo economics' in the US) by the ECB, in which the state of the real economy and regional differences are subservient to monetary stability. The outcome of this pursuit is that the ECB's objective of price stability *qua* price stability is perversely limiting the *Euro* as a world currency. The relative unimportance of fiscal activism and fiscal federalism in the macroeconomic policy framework reduces the possibility of achieving an optimal currency area in the Euro-Area, the logic of the aims of the Maastricht Treaty. A system of fiscal insurance has been shown to mitigate the effects of asymmetric shocks on regions and sectors in other currency unions. However, the "economic nonsense" of Maastricht locks in a political malaise in response to budgetary reform. The global economic growth environment appears to be weakening, particularly in the in the developed economies, and the promise of the 'new economy' as set out in the Lisbon Agenda has not yet come to the

rescue of Europe's regions either. Without a much stronger commitment to fiscal activism, the current cohesive divergence between the Euro-Area's regions is likely to continue with periodic challenges to the system's stability. The test case may be Slovenia which has joined the Euro-Area and the other Accession States who already anchor their currencies to the Euro.

In the meantime, the heady brew of a single currency dimension to the regional development of the EU, budgetary reform and stabilising enlargement in the context of a shifting global economic landscape suggest that a *Europe of the Regions* may still be some way off.

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## End Notes

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<sup>1</sup>The theory of optimal currency areas posits the view that monetary unions will operate effectively as long as factor mobility compensates for inter-economy differences. In the absence of this mobility, a system of fiscal transfers is needed to adjust imbalances between economies in the union (Mundell, 1961)