VI. TEMA A DEBATE. Coordinating the euro by Teodoro Millán[1]

Modern economic analysis has shown how monetary and fiscal policies interconnect and have to be coordinated. Or in other words, it has shown how the set of fiscal policies available to a country are not a priori compatible with any given monetary path. This situation generates a relevant coordination problem that is sometimes overcome by prioritising inflation control, effectibly imposing restrictions on fiscal budgeting and projecting monetary success into fiscal frustration *(see the Nobel laureate Christopher A. Sims, Gaps in the Institutional Structure of the Euro Area. Financial Stability Review • No. 16 • April 2012).*

The coordination problem escalates with the introduction of a multiplicity of fiscally independent countries subject to a unified currency and might become intractable if nations try to adopt antagonistic policies, because satisfying some of the countries goals may frustrate other countries needs. Such has been the experience of the euro countries during the recent crisis where continuous tension over the choice of the appropriate economic policy reveals the severity of the underlying coordination problem. Free trading across countries becomes very relevant for the well functioning of the system because the integration of markets is expected to align the member countries' economic performance making possible the selection of compatible policy targets.

But why should fiscal policies in a free trading zone differ across neighboring countries? Economies experiencing different phases of the business cycle will reach different outcomes applying the same policy rule. For instance, were one country to be on an upswing while the rest is suffering a downturn, the policies dictated by the same general formula might produce very different results according to the input, making the first country eager to push for expansion while other countries may want to adhere to a more temperate policy. In that situation, choosing a single monetary path for the countries grouped under the same currency will become a complex problem with no simple solution or no solution at all. Not only inflationary pressures and fears could coexist with their opposites across the border but also the inflation control itself admits different interpretations raising questions concerning the appropriate target; should it be the average inflation across countries or the max or the min of the group?. In fact, lack of clarity might cause more harm than benefit to the central bank in charge, compromising its political independence.

Thus, for a set of economies under a single currency free trading and market integration is crucial for aligning economic conditions and achieving harmonious performance, which constitutes a precondition for the avoidance of the coordination problem. However, what has proven valid for balancing markets where capital, goods and services move unrestrictedly through the union frontiers, does not apply to labor. Contrary to supply and demand laws, the very limited mobility of workers from low to high performing economies during the crisis has produced a migration paradox, so that unemployment has persistently accumulated in certain countries. This phenomenon has significantly contributed to the misalignment of economic conditions that spur the coordination problem.

When in the course of the big crisis the problems of some European countries demanded urgent intervention and the survival of the euro was put into question EU authorities, lacking the hindsight of prior experiences and confronted with default risks across the recently created European conundrum, focused the analysis and policy recommendations on the absolute magnitudes of public debts and running deficits to the detriment of the fundamental shortfalls of the system. Mistaking the symptoms for the causes, all efforts were directed to reducing deficits and restructuring domestic markets with no weight attached to resolving the lack of integration of the global labor market.

The coordination problem, irrelevant during the generalised affluence of the early years of the century became imposing when the radical change in the economic conditions threw countries into divergent directions. At that point, the need for political compromising crystallised by making the survival of the euro system a priority, and proscribing defaults by member estates - anticipated as exits from the euro- out of fear of jeopardising the whole system. Funding was mobilized to support countries

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and their banking systems in difficulties, and navigation out of the crisis was circumscribed to the reduction of government deficits responsible for the high risk premiums that markets were attaching to under-performing public debt. Two economic policy principles followed; that of focusing monetary policy on inflation control and liquidity provision to banks, and setting fiscal policies on the control of public deficits and on the help of bank restructuring with community funds.

However simple that approach may look it missed the fact that the coordination problem, especially recalcitrant at the beginning of the crisis, was aggravated by embracing a non-expansionary monetary policy (contrary to the innovative quantitative easing policy adopted by the Fed). Under such an option demand driven stimulus and currency devaluations became impossible to implement, to the frustration of countries willing to follow the example of low leverage and full employment economies. Instead, emphasis was put on domestic restructuring and local market liberalizations as a precondition for supporting massive bank rescues conducted via community funds and rescue packages.

Paradoxically, the exercise was promoted as one in orthodox economics, efficiency and liberalization, showing little sensibility for the malfunctioning of the integrated labor market and the ensuing conflict of legitimate but equally orthodox policies manifested in the coordination problem. That is how domestic restructuring gave way to persistent unemployment and political unrest in some countries.

If labor were able to behave as belonging to an integrated market, unemployed workers in search of a job would move into high performing countries, contributing to an efficient allocation of resources and providing for the policy alignment needed to mitigate the multi-country coordination problem.

But this was not the case, and istead the migration paradox persisted in spite of the fact that union frontiers remained open. Migration was limited to high-skilled young graduates with family support, while massive unemployment was unable to assume the high costs of migration associated with the following factors; firstly, the reallocation of residence and dependents and, in many cases, of transplanting lifelong savings materialised in real estate property; secondly, the adverse selection problem deriving from the asymmetric competition for jobs between migrant and local workers, impaired by information asymmetries, language and cultural distance and qualification and professional recognition issues. Employers, operating under limited information and the shortcomings of labor selection implied by distance, might systematically ignore better job candidates or limit expansion to local availability of workers. On the other hand, workers in the countries most affected by the crisis faced the choice of accepting underpaid jobs at home or remain unemployed, becoming de facto victims of a negative version of the free rider problem by suffering public costs without receiving appropriate compensation for them. In both cases inneficiency prevails in what might be mistaken for a free market allocation been in fact only a mere case of non intervetion depraived of the values associated to the free market mechanism.

The inefficiencies of the integrated labor euro-market, reflected in the migration paradox of polarization of unemployment in certain countries, is one of the key factors responsible for the lack of harmony in the performance of economies that ultimately result in the coordination problem of monetary and fiscal policies. Solving these market inefficiencies can be achieved through tax transfers to individuals to compensate migration costs. Overcoming the coordination problem between countries might require income subsidies from countries that benefit from not receiving the unemployed to those that retain them. Both policies will ameliorate the coordination problem while dissolving the migration paradox. In order to adopt sound and lasting political solutions to the problems of the euro economies it is very important to realize that these are fundamental elements for the well functioning of the system. Otherwise, the coordination problem might temporarily fade out during bonanza periods -as it has been the case in the pass- but it will not go away becoming a permanent threat to the europen project.