

COMMENTARY

## Chances of eurozone reform

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The eurozone crisis, which erupted only a few years after the outbreak of the global financial and economic crisis originating from the U.S. housing market debacle, has revealed weaknesses in the regional as well as global frameworks for financial and economic crisis prevention.

My concern about international institutions' surveillance of the eurozone was first expressed in a short commentary I wrote in January 2007 in response to a speech a month earlier in Australia by Mervyn King, then governor of the Bank of England. In that speech, King had argued that the International Monetary Fund should conduct surveillance of macroeconomic policy and that the Organization for Economic Cooperation and Development should focus on surveillance of structural policies.

In the commentary, I argued that utmost care would be required in rationalizing IMF and OECD surveillance activities so that it doesn't result in weakening the surveillance of interactions between macroeconomic and structural policies. To clarify, I noted that large rises in unit labor costs in several countries persisted even after they had joined the eurozone. I observed that they had weakened their international competitiveness and worsened external current accounts, and that the divergence of their unit labor cost performance from sustained declines of such cost in Germany pointed to the emergence of an underlying threat to the viability of the euro system with adverse consequences for global macroeconomic stability.

Within the eurozone, member countries competing with Germany can no longer use exchange rate adjustments to narrow relative cost disadvantages vis-a-vis Germany and to correct current account deficits and external debt. Accelerated labor and product market reform to strengthen competitiveness is the only way to prevent a buildup of macroeconomic tensions within the eurozone that could exert undesirable effects on the economies of the United States, Japan and the rest of the world.

In such a situation, in my view, surveillance of macroeconomic policies should go hand in hand with structural policy surveillance in order to prevent an anomaly whose underlying cause is the malfunction of structural policies combined with rigidity in macroeconomic policy management in the eurozone.

I thus argued that the OECD should not discontinue macroeconomic analysis and forecasting, which is essential for examining the interrelationship between macro and structural economic forces and for making recommendations on a coherent set of macroeconomic and structural policies over the medium-term.

French economist Jean Pisani-Ferry and others note that “IMF surveillance failed to take fully into account the implications of being in a currency union both for national policies and for the governance of the eurozone, whose weaknesses were not fundamentally criticized.”

On the other hand, the OECD issued warnings about some emerging fundamental problems in several eurozone member countries at a fairly early stage. For example, in December 2000, the erosion of Italy’s competitive position was discussed as a matter of particular concern in the OECD’s country note on Italy.

Such warnings were ignored by national policymakers. As a matter of fact, the correction of imbalances in the eurozone was set in motion essentially under financial market pressures that forced deficit countries to adopt fiscal consolidation and through the market-induced financial deleveraging of the private sector in these countries, pointing to the importance of financial market discipline, which unfortunately started to play its role too abruptly with a long delay.

How can we ensure the sustainability of the eurozone? This issue was discussed extensively at an international conference I organized in Paris on Sept. 23.

Based on the view that the eurozone crisis is essentially a balance-of-payments crisis as a combined result of fiscal imbalances and private-sector saving/investment imbalances in member countries, I argued that actions needed to deal with the eurozone crisis should go beyond fiscal consolidation in external deficit/debt countries.

Compared with several years ago — when I argued for the need of labor market and other structural reforms in debtor countries in the eurozone at international conferences in Europe — the importance of such reform is now increasingly recognized among European economic policy planners. A major issue now is how to secure and strengthen motivations for generally unpopular structural reform in debtor countries, given the political constraints in democratic societies.

In addition, there are questions as to the roles of external surplus/creditor countries, Germany in particular, in contributing to the adjustment of external imbalances among eurozone countries.

My own view is that fiscal expansion in Germany to offset the deflationary effects of fiscal consolidation in debtor countries would be undesirable, given that the country’s aging population will exert pressures on fiscal positions in the decades to come. Still, Germany should accelerate structural reform, particularly the liberalization of services and domestic market regulations, to stimulate imports.

That said, the enforcement mechanism of financial market pressure, which works on debtor countries, would not function in creditor countries symmetrically.

In the light of this consideration and given the limits of surveillance by global institutions such as the IMF and the OECD, as well as the effects of peer pressure in the European framework, how can the international community as a whole effectively influence policymaking in creditor and debtor countries? And what should be the role of the G-8/G-20/G-7 process of global political leaders?

In my view, we should not hold unrealistic expectations about what political leaders can do, as they face democratic accountability to their electorates. Hence the communication policies of political leaders, governments and international institutions are important for convincing electorates of the longer-run damage from myopic, populist economic policy management and for informing them about the longer-run benefits of macroeconomic adjustment and structural policies.

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