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Policy | brief

The political trilemma of the economic and monetary union

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by Nicola Acocella and Paolo Pasimeni[1]

The analysis of divergences and imbalances in the EMU suggests that failure to reduce inflation rate differentials in a monetary union may lead to increasing economic and political tensions and has indeed done so. However, it is also true that a top-down coordination of national policies for implementing structural policies in order to pursue that reduction would raise issues of democratic legitimacy. This epitomises the existential challenges that the EU faces nowadays.

Keywords: *Monetary Union, interest rate, exchange rate, inflation differentials, political trilemma.*

JEL: E42, F33, F41, F42.

In the current debate over the future of the economic and monetary union (EMU) there is concern on how to cope with the existing instability of the system and the ensuing political tensions. However, the major issue to analyse is how and why the instability could arise. This route has been recently indicated in a part of the literature (Mody, 2015, 2018; Stiglitz, 2017). This policy brief tries to go farther along this route and explain why the instability is strictly linked to structural features of the EMU.

The impossible trinity and the uncovered interest rate parity condition

The relation between interest rate and output in an open economy is strictly dependent on the exchange rate (Fleming, 1962; Mundell, 1963). If monetary cooperation evolves towards a system of fixed (or quasi-fixed) exchange rates, free mobility of capital implies that interest rates in different countries can no longer be independent. This is the foundation of the so-called "impossible trinity", which means that the three objectives of fixed exchange rates, free capital flows, and independent monetary policy cannot be pursued simultaneously. This trilemma has explicitly determined the configuration of the international financial architecture in the post Bretton Woods era, and its validity has also been empirically confirmed (Aizenman et al, 2013).

The reasoning underlying the impossible trinity is based on the observation that, in the absence of a risk premium, the difference in interest rates between two countries is equal to the expected change in the exchange rate between the countries' currencies: the nominal exchange rate appreciates if the domestic interest rate rises, or if the future expected exchange rate rises; it falls if the foreign interest rate rises. If this parity does not exist, there is an opportunity to make a profit through arbitrage, but free capital flows make sure the condition is respected almost instantaneously.

This reasoning is of particular relevance for a durable (credible) system of fixed exchange rates. In such a system, the expected and the current exchange rate between two currencies must be the same, but this implies that also the domestic and the foreign interest rates must be equal.[2] In other words, if credible fixed exchange rates are to be maintained, nominal domestic interest rates – at least interbank rates – cannot differ from foreign ones as a result of independent monetary policies. If they differed while capital movements are free, there would be large capital movements towards (from) the countries with higher (lower) interest rates/rates of return. This necessarily causes the exchange rate to shift (up with an inflow, down with an outflow).

The combination of free capital movements and independent monetary policies is incompatible with a regime of fixed exchange rates – or with the prospect of exchange rates credibly remaining fixed. On the other hand, if fixed exchange rates and interest rate equalization (i.e., a single monetary policy between different countries) are guaranteed, either capital movements ought to be somewhat controlled or other policies should be implemented to get rid of inflation rate differentials, in order to maintain the (credibility of the) regime.

The combination of free capital movements and independent monetary policies was particularly relevant in Europe during the years of the European Monetary System (EMS), and in particular at the time of the German reunification. The system of fixed exchange rates forced other countries to follow the German monetary policy managed by the Bundesbank[3].

On the basis of the experience of the EMS, the theory of the "impossible trinity" set the foundation for the EMU[4]. As the three objectives mentioned above cannot be pursued at the same time, the establishment of the EMU reflected the choice of one side of the trilemma: fixed exchange rates and free capital flows, with no independent monetary policy in the different countries.

The "uncovered inflation rate parity" condition

We argue that although monetary unification does indeed eliminate the tension between exchange rates and nominal interest rates, it does not solve the problem of the intrinsic instability of the system. By eliminating the intra-area exchange rates (with a single currency) and interest rate differentials (with a single common policy rate set by the common central bank), the problem of instability is simply transferred to inflation rate differentials, what we call the (impossibility of the) "uncovered inflation rate parity condition" in a monetary union (Acocella and Pasimeni, 2018)[5].

When the "uncovered inflation rate parity condition" is not satisfied, and the inflation rates of the participating countries diverge, with a single nominal policy rate set by the common central bank, there are two consequences. On the one side, divergences translate into a current account imbalance. On the other side, by implying higher real interest rates in lower inflation countries and lower real interest rates in higher inflation countries, they promote higher investment in the latter and a rise in credit demand and capital inflows from the former, fuelling imbalances in the capital account[6]. The more capital flows to the higher inflation countries, the more the inflationary pressure there rises. This leads to a vicious circle, which can further increase the divergences[7].

A single monetary policy for the whole area cannot be tailored to the diverging price dynamics of the participating countries, while real interest rates cannot move according to the requirements of different domestic conditions. Once countries with structurally different business cycles, diverging inflation rates and free capital movements agree on a single currency, there are no mechanisms that can ensure the equalisation of inflation rates in the short-medium run. Real interest rate differentials generate destabilising capital inflows and outflows, which, in turn, reinforce the incentives to cross-border capital flows.

The recent history of the EMU has led some authors to argue that the lack of adequate supervision in deficit countries led to a misallocation of capital inflows, therefore fuelling excessive asset bubbles and creating inflationary pressure (García-Santana et al. 2016; Gamberoni et al, 2016). Others, instead, have seen in the deflationary policies conducted by surplus countries the main reason for the building up of the imbalances (Bofinger, 2015; Johnston and Regan, 2016). Both points of view suggest that a central European authority should be capable of imposing corrections, thereby challenging the policy preferences of member states.

The seemingly only technical problem of inflation rate differentials leads, therefore, to political problems through economic imbalances and divergences. The reason is that a number of policies and institutions are different in various member countries, which leads to asymmetries. If the policies and institutions remain uncoordinated, they inevitably generate imbalances, which can become permanent and exacerbated. This is a key source of fragility of the system, as any financial stress can disrupt the precarious equilibrium, putting pressure on the relatively higher-inflation countries that must attract international capital flows to balance their trade deficits. The developments after the financial crisis have shown this plentifully.

Policy implications

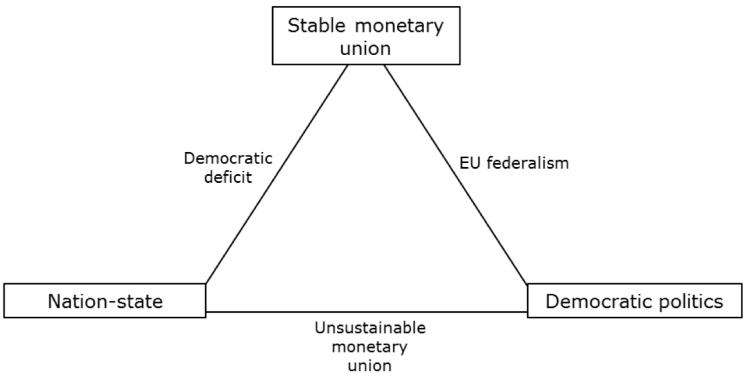
The question then becomes how the difference in the inflation dynamics can be best kept in check and which institutional level is the appropriate one to address this challenge. The "uncovered inflation rate parity condition" calls for a coordination of the national structural and fiscal policies, for the single monetary policy to work without it amplifying imbalances. In this perspective, in order to avoid disequilibria and the need for corrections, a central authority should be equipped for ensuring and enforcing a stronger coordination of national policies. This would challenge the policy preferences of national governments.

Respecting the parity condition implies keeping the price dynamics of every single participating country constantly under control and achieving a quasi-perfect coordination of national policies. This requires interventions on the evolution of the national economic structures and a stronger coordination of wage developments in each country as well as of labour and product market regulations. It also requires coordinating national fiscal policies, in a differentiated, but permanent, way[8].

In other words, for the EMU to work effectively, a supranational authority would need to be extremely intrusive, taking decisions on matters which are at the core of the national political processes. This would inevitably erode and constrain the prerogatives at the national level, thus leading to issues with democracy. The process of top-down economic policy coordination would inevitably touch upon the most politically salient areas of national policies (Leino and Saarenheimo, 2017). This poses an important problem of compatibility between the sustainability of the monetary union and the exercise of the democratic prerogatives at a national level.

When strict coordination and the ensuring of democracy together with self-determination within the nation-state are desired, a trilemma arises. Self-determination in the nation states, democratic politics and full economic integration are mutually incompatible (Rodrik, 2007; 2011; 2017). The uncovered inflation rate parity condition, then, leads us to the application of Rodrik's trilemma to the EMU:

Figure 1: The political trilemma of the economic and monetary union



Source: adapted from Rodrik (2007).

If we deem democratic politics and full economic integration to stabilise the monetary union to be the higher-level objectives, nation-state sovereignty should be reduced: unified markets and even more a monetary union require supranational governance. A larger role for the self-determination of the nation state, instead, requires some limits either on the integration or on democratic choices. Full economic integration would require dropping either democratic choices within the nation states or self-determination of the participating countries; then political unification and governance should also be added. This includes EMU action for dealing with country inflation rates, e.g., through structural policies, and some kind of control of capital movements[9].

Conclusion

Building a stable and sustainable monetary union, legitimised by a democratic process of policy making, would require a move towards a European federation – something that is currently openly opposed and ruled out by many constituencies. The concern is that decisions on key value judgments can only be made legitimately within fairly homogeneous communities (Leino and Saarenheimo, 2017).

Preserving democratic choices and policy making at national level would make it impossible to reach the level of quasi-perfect coordination of key areas of economic policy making that the "uncovered inflation rate parity condition" would require to be satisfied, and therefore the monetary union to be stable and sustainable. A historical review of currency crises shows that persistent inflation differentials are consistently associated with a high likelihood of a currency union dissolution (Nitsch, 2005).

Pursuing a top-down coordination of national policies, in particular in all sensitive areas, and bypassing the electoral processes in order to fulfil the "uncovered inflation rate parity condition", would exacerbate the lack of democratic legitimacy. The political trilemma of the economic and monetary union epitomises the existential problems the EU faces, and the "uncovered inflation rate parity condition" is at their core.

Endnotes

[1] Nicola Acocella is Emeritus Professor of Economic Policy at Sapienza University of Rome; Paolo Pasimeni is Senior Associate Researcher at the Institute for European Studies (IES) of the Vrije Universiteit Brussel (VUB). The opinions expressed in this column are the authors' alone and cannot be attributed to the institutions they belong to.

[2] The two interest rates may only differ due to the presence of a "risk premium" due mainly to political risk, linked to specific characteristics of the two economies.

[3] Eichengreen, Wyplosz (1993) model the attitude of Germany as a leader after re-unification and the effects of this on the crisis of the EMS of 1992-93.

[4] The trilemma was applied to the EMS by Padoa-Schioppa (1982), who spoke of an impossible quartet (the fourth element being free trade), and was popularized by Krugman (1987, 1999).

[5] For a mathematical derivation of the condition see Acocella and Pasimeni (2018).

[6] Lane, McQuade (2013) find a positive correlation between net capital inflows and domestic credit.

[7] See Sinn (2010), Lane and McQuade (2013), Hale and Obstfeld (2014), Gabrisch and Staehr (2015), Storm and Naastepad (2016).

[8] When financial cycles are not synchronised across countries, another layer of complexity is added, Obstfeld (2015) has even suggested the incompatibility of national responsibility for financial policy, international financial integration and financial stability, so that macro-prudential policies become another important area requiring stronger coordination.

[9] Freedom of capital movements is one of the founding tenets of EMU, but there are various tools that can at least diminish their reactivity, e.g. by establishing a common deposType equation here.it insurance.

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About the authors

Nicola Acocella
Emeritus at Sapienza University of Rome, formerly Full Professor of Economic Policy
His fields of specialisation include: welfare economics, theory of economic policy, policy games, monetary policy, fiscal policy, European integration, globalisation, industrial organisation, labour markets and unions. Author of more than 100 papers published in high-ranked journals and of various books, among which Foundations of Economic Policies, Economic Policy and corporate strategies, Rediscovering Economic Policy as a Discipline and (with G. Di Bartolomeo and A. Hughes Hallett) The theory of economic policy in a strategic context and Macroeconomic paradigms and economic policy, all with Cambridge University Press.

Paolo Pasimeni is a Senior Associate Researcher at IES-VUB, his main field of expertise is the macroeconomic analysis of the euro area and the design of options for completion of the economic and monetary union (EMU). He has also experience on labour market analysis, on the analysis and conception of the EU budget, on cohesion policy and on research and innovation.