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The reaction of the U.S. and the European Monetary Union to recent global financial crises

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This paper analyzes the responses of the United States and the economies of the Economic and Monetary Union (EMU) to the financial and economic crisis of 2008–2009. The crisis illuminates the fundamental structural problems within the EMU, the European Union and the United States and the scale and scope of interconnections among the world economy. The paper focuses on the reactions of the real sector to the financial disturbances in these economies. Both comparative static and dynamic methodologies are used in order to appraise the scope and pace of adjustments in response to the global crisis.

1. Introduction

This paper assesses the reactions of the United States and the twelve economies of the Economic and Monetary Union (EMU) to the financial and economic crisis of 2008–2009. The rapidly spreading financial and economic contagion uncovered structural problems of each member of the EMU that impacted their relative competitiveness. Furthermore, the crisis highlights the scale and scope of interdependences in the world economy. It unveiled economic and institutional flaws in the EMU, the European Union (EU) and the U.S. Additionally, in the U.S., the crisis brought to light institutional and industry conflicts of interest, as well as glaring regulatory failures. This paper focuses on the reactions of the real sector to financial

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disturbances in the economies of the EMU and the United States. Both comparative static and dynamic approaches are used in order to appraise the scope and pace of adjustments in response to the global crisis.

Subsections 1.1 and 1.2 provide a brief discussion of the political and economic context of the EMU, the role of the U.S. in the global economy and how its policy affects worldwide economic dynamics. Subsections 1.3, 1.4 and 1.5 address the major mechanisms of the 2008–2009 crisis, which led to the global slowdown, both from its inception in the U.S. to its spread into the EMU economies. Section 2 covers the empirical part concerning the 2007–2010 period and the fiscal performance of EMU countries and the U.S. Section 3 examines the reaction of the real effective exchange rates (REERs) during the crisis. Section 4 discusses trade developments generated by both REERs' adjustments and the crisis. Section 5 describes the consequences of the crisis and its relation to the labor markets. Section 6 details the effects of the crisis on a comprehensive set of performance measures, such as gross domestic product (GDP) and gross national income (GNI). Section 7 concludes.

1.1. The EMU in the global context

The acceleration of globalization in the 1980s and 1990s stemmed from both political developments and technological progress. Globalization was supported by the revival of neoclassical economics (Blanchard & Cottarelli, 2010; Blanchard et al., 2010). Since the 1980s, practice of international economic policy was strongly influenced by the publications of the National Bureau of Economic Research (NBER) and the Organization of Economic Cooperation and Development (OECD). They questioned ideas on the currency and trade policy at that time yet postulated the liberalization of the circulation of goods and capital, as well as the shift from fixed to floating exchange rates (Findley and O'Rourke, 2007; Rodrik, 1996). The process was enhanced by the International Monetary Fund (IMF) policy of conditionality towards emerging market economies (Kowalik, 2002, p. 277) and by the growing popularity of the Washington Consensus (Williamson, 2003).

These processes sped up the European economic integration of the 1980s, and strengthened the institutional and decision-making framework (the Single European Act). Other countries observe this as both an inspirational example and as a challenge (Di Mauro et al., 2008; Dyson & Featherstone, 1999; Findley and O'Rourke, 2007; Gilpin, 2000; Pelkmans, 2006).

The Delors Committee, beginning in 1988, worked toward the creation of a monetary union. The process intensified following the fall of the Soviet Union and the German unification. The Maastricht Treaty formalized this policy, foreseeing the formation of the EMU (De Grauwe, 2000; Issing, Gaspar, Angeloni, & Tristani, 2001; Ungerer, 1997). The EMU project was based, in part, on the concept of Optimum Currency Area (OCA) (Kenen, 1969; Mundell, 1961, 2011).

The monetary and fiscal criteria, stipulated in the Treaty of Maastricht, were neither a simple reflection of the OCA criteria, nor easily justifiable by economic theory (De Grauwe, 2000). They reflected the arbitrariness of political decisions that led to the establishment of the monetary union (Kowalski, Kowalski, & Wihlborg, 2007). EMU convergence criteria originated from a political bargaining process that had started as early as 1987 and concluded during the Inter-Governmental Conference (IGC), which paved the way to the Maastricht Summit (Dyson & Featherstone, 1999).

During the IGC, the emphasis on the ex-ante criteria and the lack of ex-post disciplinary measures were hardly debated. The arbitrariness of the actual levels of the fiscal Maastricht criteria was criticized only after their draft was approved. Pasinetti (1998) and Laufer (1997) noted that the Maastricht criteria were tailored according to the historical economic performance of Germany. In fact, the fiscal criteria could be derived from a formula determining the budget deficit needed to stabilize government debt (De Grauwe, 2000; cif. Bini-Smaghi, Padoa-Schioppa, & Papadia, 1993).[1]

During the preparations for the introduction of the EMU, Germany requested an institutional correction and proposed the ex-post disciplinary measures. This correction, the Stability and Growth Pact (SGP), was finally added in 1997. The rationale behind the SGP was that the EMU member countries,

[1] $d = gb$, where d is the budget deficit (in percent of GDP; 0.03), g is the growth rate of nominal GDP (assumed to be 5%; 0.05); and b the steady state level of public debt to be stabilized (60%; 0.6). This formula indicates the required combination of these three parameters in order to stabilize the public debt level (here at 60% of GDP — at the time it was the average debt — to GDP ratio in the EU) and assuming the growth rate nominal GDP to be 5%.

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