

Comments on *Regional Nonadjustment and Fiscal Policy* by Maurice Obstfeld and Giovanni Peri. Economic Policy 26.

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Within a currency area, absent internal nominal exchange rates, adjustment to asymmetric shocks must take place through changes in relative prices. When prices and wages are not flexible enough to compensate for the absence of nominal exchange rates, asymmetric shocks might lead to regional recessions and persistent regional unemployment differences. If the labor force is mobile, workers will migrate to booming regions making the adjustment less costly (at least in terms of unemployment). In the absence of migration, interregional fiscal transfers can help smooth the negative effects of these shocks.

This paper studies all these mechanisms of adjustment using regional data from a sample of European countries, the U.S. and Canada. The paper nicely integrates previous results in the literature with new evidence produced by the authors to understand the likely consequences of asymmetric shocks in the future European Monetary Union.

I will comment separately on the findings of the authors for each of the adjustment mechanisms before I review the lessons for EMU.

Adjustment through migration.

It is difficult to disagree with the conclusion that migration can play a limited role in the adjustment to asymmetric shocks under EMU. The results from the VAR analysis show that there is little migration (in the first years) in response to asymmetric shocks within European countries. International migration in EMU will surely be even lower as culture and language impose additional barriers to migration. The comparison with the U.S. illustrates how a mobile labor force can help the functioning of a currency area. I have, however, two small caveats about these results. I am not so convinced about the reading that the authors make of the dispersion of regional unemployment rates. In most European countries there are persistent differences in regional unemployment rates and, in cases such as Italy, these differences have increased over time. What does this say about migration and asymmetric shocks? Econometrically it is impossible to establish whether these differences are the result of regional shocks that, because of the lack of migration, result in persistent differences in unemployment rates (as the authors argue) or they have their origin in diverging trends in regional unemployment rates (i.e. the upward trend in unemployment has not had the same effects in all regions).¹ As the authors also admit, one has to be careful about the long-term responses produced by the VAR analysis. Because of the econometric specification and the short time series, there is a lot of uncertainty about the long-term effects of shocks.

Adjustment through prices.

¹ As a result, if one wants to study the persistence of unemployment rates, allowing for different regional trends (as the procedure of Decressin and Fatás (1995) does) produces less persistence than restricting the trend in the unemployment rate to be the same for all regions (as this paper does).

The paper adds new results to the known fact that relative regional prices tend to fluctuate less than international relative prices. The authors admit the difficulties associated to interpreting their results because the volatility of relative regional prices is an endogenous variable. I would like to add one more caveat to their list. Under fixed but adjustable exchange rates, real exchange rate variability might be the result of infrequent and large nominal exchange rate realignments. Indeed, some of the European countries in their sample which show a very high variability relative to Germany are countries which belonged to the ERM system and went through several large realignments. In the ERM, countries with higher inflation experienced real exchange rates appreciations until a crisis took place with the associated large real depreciation. This is totally unrelated to asymmetric shocks and relative price adjustment. The fact that Greece, which never belonged to the ERM and saw its exchange rate constantly depreciate because of higher inflation, has a low real exchange rate variability supports this explanation.

Adjustment through fiscal transfers.

The authors present new evidence about the size and timing of fiscal transfers in response to fluctuations using regional data from Italy, Canada and the U.S. Their results are, in most cases, in agreement with previous estimates. Their dynamic estimation shows that transfers are very persistent and, as a result, the distinction between stabilization and insurance is very difficult to establish. Moreover, the persistence of transfers raises serious questions about the moral hazard effects of those transfers. Although it is hard to find definite empirical evidence in this direction, the evidence presented suggests that there are perverse effects of fiscal transfers to regions with low income per capita. Because of these difficulties, the authors present an interesting suggestion, to create a system where governments issue debt denominated in Euros indexed to nominal per capita GDP growth. If the arguments in favor of the creation of a fiscal federation are based on risk-sharing arguments, this proposal, or a variant of it, should be seriously considered.

It is also interesting to see from the results for the Italian federation that the system of transfers plays only a small stabilizing role. A tentative conclusion from these estimates could be that the true benefits of the current national systems are more related to the cohesion that results from redistribution rather than from their insurance benefits. Or, alternatively, one could say that the current systems are more responsive to larger shocks (e.g. German unification) than to small year-to-year changes in relative income. Because of its long-term nature, some of these issues go beyond the debate on exchange rates and the adoption of a single currency.

What do we learn about regional adjustment in EMU?

A possible reading of all the above results is that given the rigidity of prices, the lack of labor mobility and the absence of a European system of fiscal transfers, EMU members are not equipped to deal with asymmetric shocks. As a result, we should expect deep regional (country) recessions due to the presence of asymmetric shocks and the absence of exchange rates. There is, however, an alternative, and more optimistic for EMU, reading of the results. First, I have doubts about the very favorable picture portrayed by the authors about the benefits of exchange rate

policy. When thinking about the implications of EMU one has to take into consideration the way in which European countries (both ERM and non-ERM members) have dealt in the past with asymmetric shocks. I do not think that there is enough empirical evidence to support the claim that changes in nominal exchange rates have offset asymmetric shocks and allowed a quick adjustment to the new equilibrium. Second, all the evidence presented in this paper relates to regional adjustment within European countries. If the above conclusion about the possible effects of asymmetric shocks under EMU is true, a puzzle remains. Given that Germany or Italy or France are currency areas with rigid prices and wages and little labor mobility, why is it that they have survived the presence of asymmetric shocks? One could argue that asymmetric shocks are more prevalent at the national than at the regional level. This paper does not address this issue but recent results in the literature of optimum currency areas do not seem to support this claim and, moreover, after EMU takes place we might observe less asymmetries at the national level as a result of deeper trade integration and coordination of economic policies. An alternative explanation to the survival of current currency arrangements is that the national systems of fiscal transfers have provided enough support to regions going through recessions. Given the results presented in this paper, this answer is not fully convincing. The estimates of the stabilization provided by national systems are small (especially in the case of Italy). One could further argue that some of the results suggest that the benefits are not coming from stabilization per se but from the fact that the system of fiscal transfers provides redistribution and maybe transfers for large and rare shocks (not captured by yearly changes in regional GDP or income growth). These transfers provide the political cohesion needed for the currency area to be successful. Indeed, this seems to be supported by the fact that current debates on fiscal transfers, both at the national and European level, rarely discuss risk-sharing arrangements. Finally, as argued in the paper, the economic benefits of some of these transfers are reduced, or even outweighed, by the perverse moral hazard effects that they cause in the receiving regions.

To conclude, the results presented in this paper are certainly bad news for European regions because of the lack of labor mobility and the absence of relative price adjustment. However, they might be considered as not so bad news for EMU. This paper shows how current currency areas (countries) formed by European regions are successful even if regional prices are not flexible, interregional labor mobility is practically absent and fiscal transfers stabilize asymmetric fluctuations only to a limited extent.