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*Research Report on EU*

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## *EU Faces Increasing Regional Disparities*

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The EU has not reduced the pace at which it is augmenting its size, even after the recent increase in the number of member states to 27. In contrast to this steady expansion in the size of the EU, there are more people opposed to its further regional integration, and who anticipate that the larger adjustment costs for integration will be borne by current members. In fact, although the current EU economy as a whole is relatively well with a fall in the unemployment rate, a survey of the economies of all the euro-area members shows several signs of potential economic problems concerning adjustments in its trade and industrial structure and its macro-economic policy management after consolidating mutual exchange rates following the introduction of the euro as a common currency. In this research project, we thus focused our attention on and tried to elucidate the costs of integration in the EU and their causes.

### *“Democratic Deficits” Worrying EU Citizens*

Having succeeded in fully adopting a single currency in 2002, the EU intended to implement further deepening of integration by establishing the European Constitution. However, there is already an increasing disparity in the economic performance of member states, and the people in France and the Netherlands, two of the founding member states that have promoted EU integration for a long time, voted against ratifying the Constitution. It is frequently pointed out that “democratic deficits”, a systemic defect whereby it is difficult to reflect the opinions of European citizens in the union’s policy decision-making, is one cause for their rejection. Not all substantive decisions in the EU are made by the European Parliament, whose members are directly elected by European citizens, but are made instead by the European Council consisting of cabinet members sent by the governments of the member states. This system makes it hard for EU citizens to have their opinions incorporated into the union’s decision-making regarding the direction and pace of further integration. But the problem of “democratic deficits” is not a simple political one, but stems from the unexpectedly high economic costs arising from integration.

The current euro-area member states, having determined to form a monetary union, made efforts to suppress inflation and fiscal deficits, reduced interest differentials, and finally consolidated the exchange rate planned in 1999 by jointly introducing the euro as a common currency. Of course, not all the member states have succeeded in abiding by the predetermined conditions that had to be met to join the monetary union.

In particular, Germany, France and Italy have been unable to keep the ratio of fiscal debt to GDP within 60%. However, to accept new member states, it is critical for the EU to devise and impose penalties on violating countries and to maintain intra-union discipline. It is also imperative for the EU to maintain its self-imposed discipline, for there are more countries in central and eastern Europe that perceive significant benefits from joining a larger economic bloc with a unified currency and lower transaction costs.

It has not been made clear what monetary union is costing each of the member states. Such union requires the exchange rates with the other member states to be constantly consolidated. Choice of the exchange rate system does not matter for a country if its domestic prices and wages are flexible. This is because flexible prices and wages adjust all the relative prices, thereby realizing full utilization of resources, including labor, regardless of the exchange rate determination.

### ***Strong Labor Unions and Wage Determination***

However, if wages are rigid for any reason, deficiency in the effective demand gives rise to involuntary unemployment and distorted trade and industrial structures due to rigid relative prices. Even if product prices converge in the EU after elimination of trade barriers and free capital mobility, monetary union will affect the real side of each member state's economy in the absence of labor mobility reducing the wage differentials within the union.

To form the Economic and Monetary Union (EMU), the required rates of exchange rate adjustment differed significantly among the member states. Compared with the 1970s, when the EMU was proposed, Germany, the Netherlands and Austria were forced to allow their currencies to appreciate markedly while Italy, Spain and Portugal were allowed to let their currencies depreciate significantly, but France, Ireland and Finland joined the monetary union with little change to their exchange rates.

The trade balances after monetary integration differ across the euro-member states both inside and outside the euro area. In trade with states both inside and outside the euro area, Germany, Ireland and Finland have augmented their surplus, but Italy, Spain, and Portugal have suffered from a worsening trade deficit. On the other hand, there are some countries like the Netherlands and Austria that have experienced a reversal in the trade balance between states inside and outside the euro area.

Given the economic convergence in the growth rates observed among countries, it is difficult to account for those differences by output growth differentials across the euro area countries. We should seek its cause in the supply side, such as differences in trade and the industrial structure among member states. In fact, the available data show that a country with higher growth in productivity tends to augment the larger trade surplus.

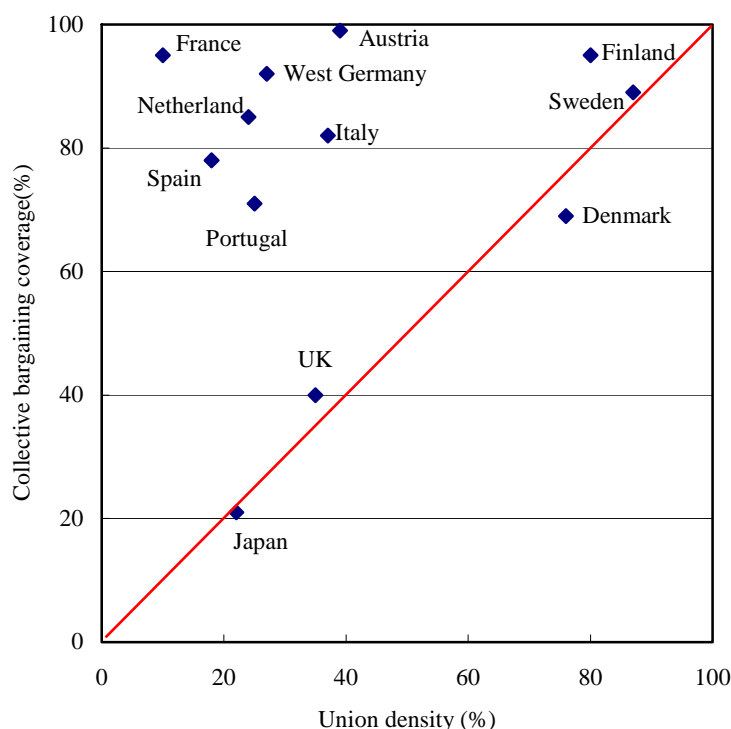
Since the adoption of a single currency, the trade pattern of each member state within the euro area has come to be determined by its absolute advantage over the other member states, while its trade pattern in relation to non-member states is still governed by its comparative advantage structure. These asymmetric determinants of the trade pattern, coupled with each country's labor market rigidity, should have resulted in each member state incurring large adjustment costs in joining the monetary union at the artificially predetermined exchange rate.

Furthermore, after participating in the euro area, a country must also bear another cost arising from its inability to use monetary policies to counter domestic economic disturbances. This generated a lot of economic costs. There would have been additional gains from monetary integration if the rigidities in prices and wages had been removed first. The reality is that we need not only free mobility in commodities and capital but also labor so as to relax the still limited flexibility in prices and wages in each member state. However there are some institutional barriers against further labor mobility in the euro area.

One barrier is the wage determination system in the EU, which tends to prevent the smooth flow of workers within the region despite the high unemployment rate. Particularly in the euro area, trade unions exercise decisive power when it comes to wage determination. This is because many countries have institutionalized the extension law which, despite the low union density, allows the outcome of the wage bargaining between the trade union and the management to cover a wider range of the labor market.

This tendency is remarkable in the so-called Big Four (Germany, France, Italy and Spain), which suffer from higher rates of unemployment. In France, for example, 95 per cent of employees are covered by collective wage-bargaining, while only 10 per cent of employees join trade unions.

### Union density and collective bargaining coverage



Source: Nickell, S. (2006), "A picture of European unemployment: Success and failure," in *Structural Unemployment in Western Europe: Reasons and Remedies*, ed. By M. Werding, the MIT Press.

### *Little Incentive to Seek Jobs in Other Member States*

When a country employs a flexible exchange rate system, then wages, by raising domestic prices, decrease the real money supply and export demand. If upward pressure on interest rates from decreased real money supply outweighs the downward pressure from reduced effective demand caused by decreased exports, then the country will face an appreciation in its currency. This currency appreciation works to lower the prices of imported consumables and to diminish wage demands made by trade unions. However, under a fixed exchanged rate system such as the EMU, trade unions tend to demand higher wages to secure their target real wages compared to the flexible exchange rate system. This is because the gains from cheaper imports in the flexible exchange rate system are lost.

Determination of minimum wages is also affected significantly by collective bargaining in many countries. The European conventional wisdom to support social security also helps trade unions to keep the minimum wages relatively high. In fact, the rate of increase in minimum wages often exceeds that of consumer price increase. Such high (real) wages impede the expansion of job opportunities.

Effective working of the EMU requires enough labor mobility within the euro area. However, there are many impediments acting against intra-regional movement of mid-level workers, such as significant language barriers and the lack of a portable, cross-border pension system.

Consequently, a large part of the labor flow in the EU is still observed only among the foreign workers coming from non-EU countries who work for the minimum wage. In addition, owing to the high unemployment rate, they are often allowed limited access to jobs in the EU, with the exception of skilled workers and jobs in sectors suffering serious labor shortages. But one should note that the high unemployment rate makes the jobs in the EU riskier and less attractive for those seeking long-term employment because the probability of acquiring of a high paying job is low.

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