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**HOW AMERICA ADJUSTS TO MONETARY UNION**

By: Erik Jones



The long essay by Paul Krugman in the 12 January 2011 New York Times Magazine has focussed a lot of attention on the role that federal fiscal systems and integrated labor markets can play in stabilizing a currency union. Since the European

Union has neither a federal fiscal arrangement nor an integrated labor market, the implication is that it will have much greater difficulty adjusting to a common currency. Countries that run into trouble while participating in the euro will face long periods of high unemployment and grinding real wage deflation as they struggle to regain and maintain competitiveness without the benefit of a national monetary policy or a flexible exchange rate. By contrast, U.S. states can draw on federal transfers to prop up their consumption while any unemployed workers look for jobs elsewhere.

The concern is not whether Europe meets the criteria of fiscal or labor market integration. No-one would suggest that it does – or, indeed, that many Europeans want to see more significant fiscal and labor flows across borders. The real concern is whether any of that actually matters for regional adjustment in a monetary union like the United States. Krugman insists that it does. The data is less straightforward. As a result, some of the developments within the U.S. monetary union are counter-intuitive given the theory that Krugman presents.

Consider the comparison between the states of New England and the Southwest. These two regions make for a good comparison because they had sharply contrasting experiences in the late 1970s and early 1980s. New England busted and then boomed; the Southwest boomed and then busted. This story is interesting to me because I grew up in Texas and I remember the changeover vividly. If you look at nominal income per capita, the shock emerges as a permanent change in the growth trajectory. The two regions grow together and then suddenly part company. The pattern is even easier to spot if we focus on the ratio of wage and salary disbursements per employee relative to the U.S. average. Workers in the Southwest become too expensive; workers in



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New England become relatively cheaper; and then their fortunes reversed.

The point to note in this comparison is that the divergence in regional performance is permanent. New England wages go up and stay up while wages in the Southwest go down and stay down. In part this is a result of labour force dynamics. Despite the adverse contrast in wages and per capita income, more people move to the Southwest than to New England. The two regions start with roughly similar populations in the late 1960s and yet end up looking very different four decades later. Meanwhile, the share of population in employment in New England grows more than in the Southwest.

A perverse feature of U.S. federal fiscal flows may also play a role in the permanent divergence in regional performance. If we use the average for the United States as a benchmark, New England starts off with a relatively high per capita income and per capita transfer payments. The Southwest has a lower relative per capita income and relative per capita transfer payments that are even lower still. Hence while it looks like transfers may absorb some of the changes in income, it is also clear that they constitute a source of continuous regional advantage for rich New Englanders and disadvantage for poor Southwesterners.

Another interesting comparison is between the Southeast (or 'Old South') and the Mideast region that stretches from New York to the District of Columbia. This is not a tale of shock and adjustment; instead it is a demonstration of structural advantage and disadvantage. Consider the performance of salaries and wages per employee relative to the U.S. average. The Mideast does well; the Southeast does not. Nevertheless, population moves against the grain. The wealthy Mideast expands by very little; the population in the Southeast grows quite a lot. Finally, the balance of transfers remains skewed in the wrong direction. The rich get more and the poor get less. And while it is true that the level of per capita transfers to the Southeast has increased, it is also worth considering how many New Yorkers like to retire in Florida. Hence the share of old age pensions and Medicare payments in the total flow of transfers to the Southeast is consistently about seven percentage points higher.

These pictures reveal a more complicated influence of integrated labor markets and common fiscal institutions than the theory of monetary integration suggests. Although it is possible that such institutions will aid in adjustment, they may also push in the other direction – with continuous inflows of migrants holding down wages while state and local governments respond by reining in social benefits. Whatever the reason, in the

## problems

25.06.2010

For two years now, leading policy makers, academics and businessmen have been meeting for discussions in the Global Economic Symposium to provide concrete solutions for the most pressing global governance issues the world will be facing this century. Here is the result of these discussions: a repository of concrete policy proposals.

Southwest and Southeast regions of the United States shocks are permanent and so are relative income differentials. The currency union has survived nonetheless. What has not survived is any consensus on the virtues of having a large federal fiscal system or even a large federal government. Europeans are probably right to avoid the kind of controversies that a federal fiscal system can engender.

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