

ECONOMIC AND MONETARY UNION IN EUROPE

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Fragility of Monetary Union

- Traditional OCA-theory correctly identified need for avoiding economic divergences in monetary union
- But failed to stress fragility of a monetary union
- Fragility arises from fact that member country governments issue debt in a “foreign” currency, i.e. a currency they have no control over
- This makes it possible for liquidity crises to arise in self-fulfilling way: fear of liquidity crises can precipitate one
- And this can degenerate into solvency crisis

- Pushing countries into bad equilibrium
- Characterized by punishingly high interest rates, a deep recession, forced austerity that deepens the recession further
- And banking crisis.
- Very much like in emerging countries (see the work of John)

Test of Fragility Hypothesis

- We perform econometric test
- Using Eurozone countries and sample of developed “stand-alone” countries during 2000-11
- Findings
 - Spreads in Eurozone countries can be driven by market sentiments that are independent of observed fundamentals
 - This syndrome is not observed in the sample of stand-alone countries
 - Markets are less tolerant about high government debt in Eurozone countries as compared to stand-alone countries

- Thus, the story of the Eurozone is also a story of self-fulfilling debt crises, which in turn lead to multiple equilibria.
- Countries that are hit by a liquidity crisis are forced to apply stringent austerity measures that force them into a recession, thereby reducing the effectiveness of these austerity programs.
- There is a risk that the combination of high interest rates and deep recessions turn the liquidity crisis into a solvency crisis.

Policy Implications

- We analyze three policy implications
 - 1) The first one relates to the role of the ECB;
 - 2) The second one has to do with macroeconomic policies in the Eurozone;
 - 3) The third one relates to the long-run need to move into a fiscal union

(1) The common central bank as lender of last resort

- Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because the central bank will provide all the necessary liquidity to the sovereign.
- This outcome can also be achieved in a monetary union if the common central bank is willing to buy the sovereigns' debt in times of crisis.
- In doing this, the central bank prevents panic from triggering a self-fulfilling liquidity crisis that can degenerate into solvency crisis
- And avoids pushing countries into bad equilibria

How to design such interventions?

- Follow Bagehot
- **Unlimited** liquidity support to illiquid but solvent countries (Greece would not qualify; Spain does)
- Apply **penalty rate**
- How? ECB announces it will not allow Spanish bond rate to exceed German rate by more than, say, 300bp.
- If credible, little intervention will be required because the announcement makes investment in Spanish bonds attractive: **magic of credibility**

ECB has finally acted

- On September 6, ECB announced it will buy unlimited amounts of government bonds.
- Program is called “Outright Monetary Transactions” (OMT)
- In defending OMT, Mr Draghi argued that “you have large parts of the euro area in a bad equilibrium in which you may have self-fulfilling expectations that feed on themselves” . . . So, there is a case for intervening . . . To ‘break’ these expectations, which. . . do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank”

- This is the right step
- There is danger, though, that its effectiveness will be reduced by politically inspired limitations
 - Bonds with maturity less than 3 years will be bought
 - Conditions of even more austerity may be imposed
- Note also that while necessary, OMT is not sufficient
- I come back to this

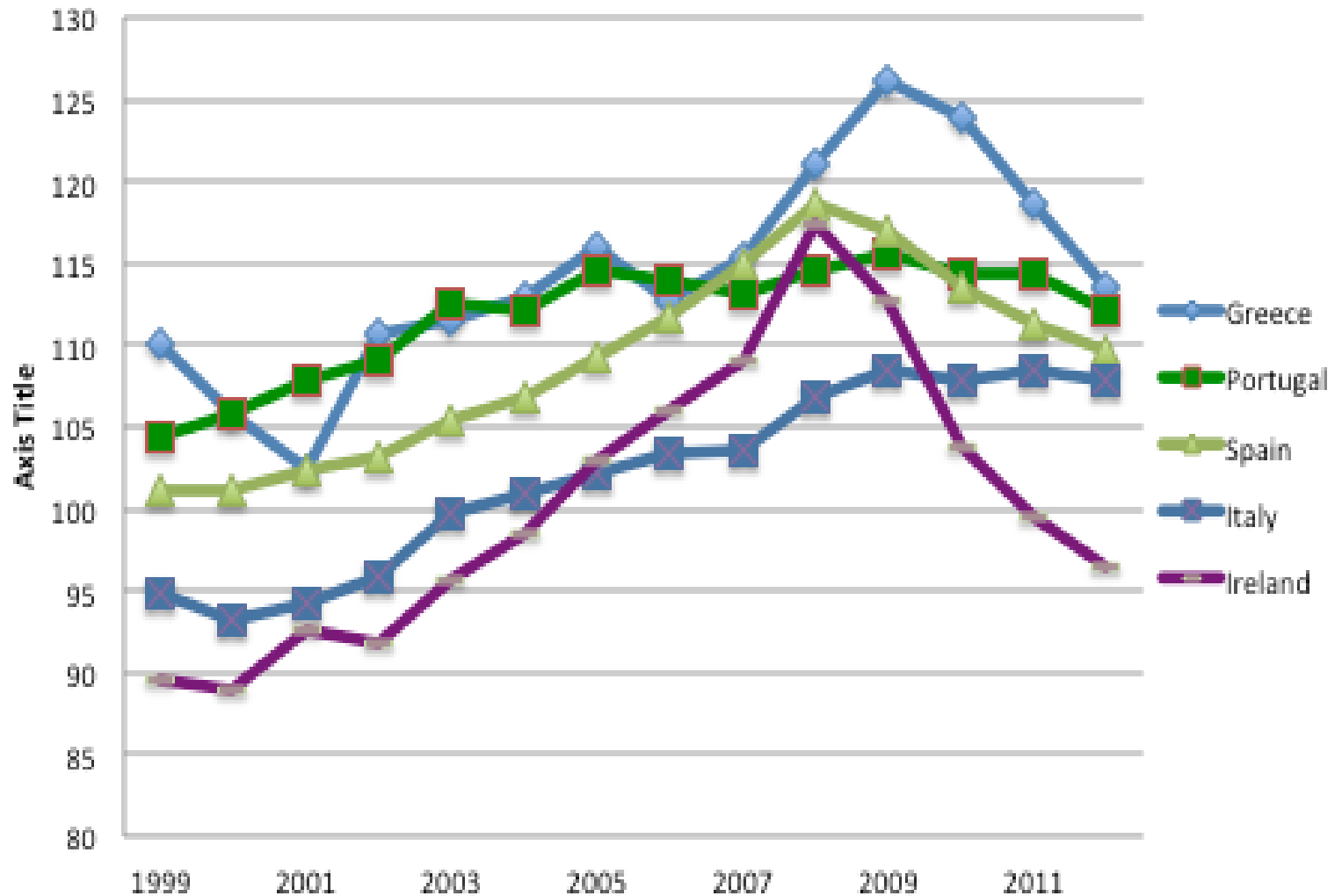
Towards new business model for the ECB

- Problem of ECB is that it is too concerned about quality of its balance sheet and its profits and losses and
- not concerned enough about financial stability
- An example of misplaced concern about its balance sheet: claim to seniority on its holdings of government bonds
- This has made bond purchases counterproductive
- Happily ECB has dropped seniority claim when it announced OMT
- Moving towards new business model?

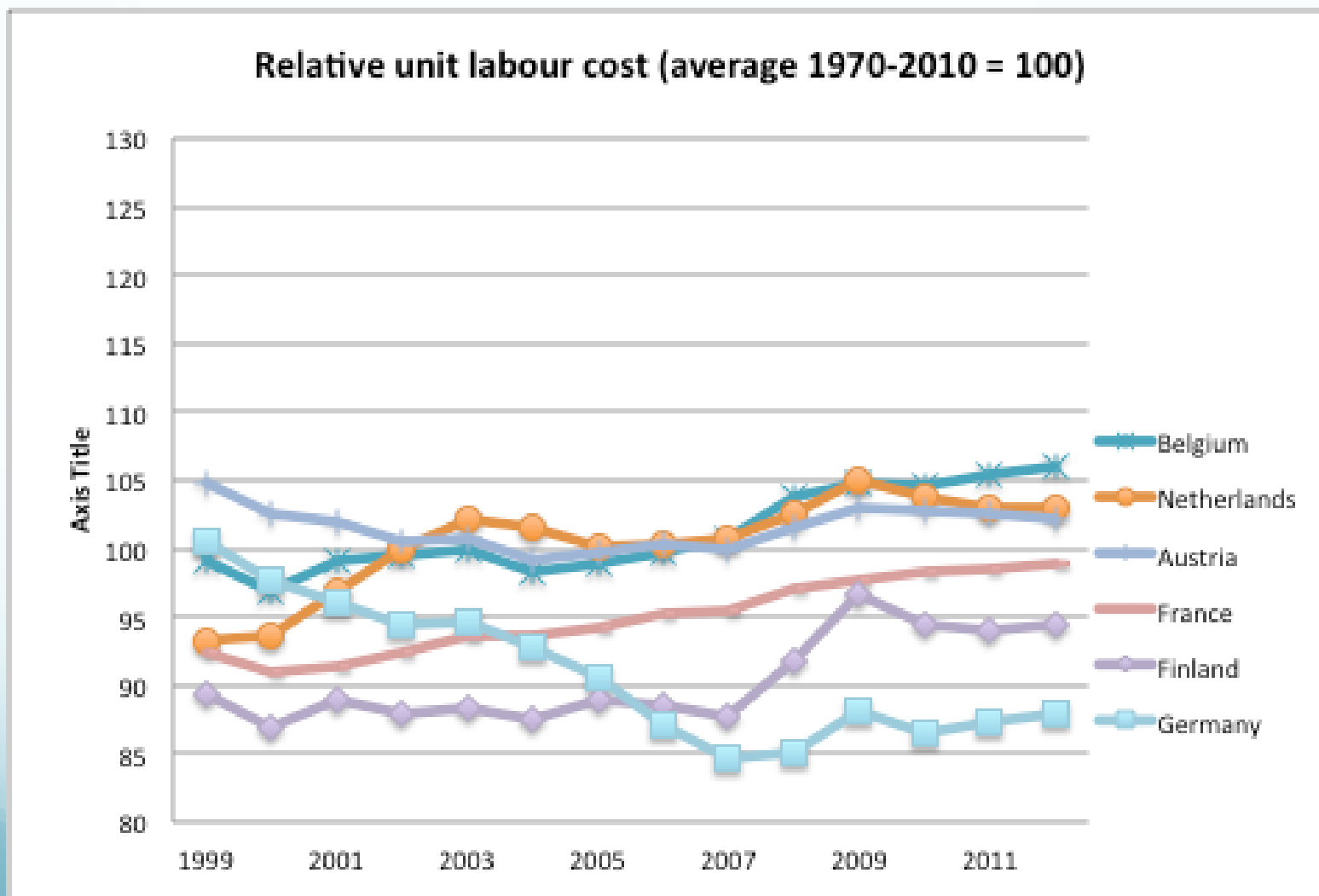
(2) Symmetric Macroeconomic Policies

- Markets have pushed some countries in bad equilibria (Spain, Portugal, Ireland) and others in good equilibria (Germany)
- Authorities should not accept this market outcome, which is the result of fear and panic.
- Unfortunately macroeconomic policies exclusively geared towards austerity in the South reinforce the split between countries in bad and in good equilibria

Relative unit labour cost (average 1970-2010 = 100)



What has been the contribution of the Core countries in the adjustment?



Interpretation

- Burden of adjustments to imbalances in the eurozone between surplus and deficit countries is borne almost exclusively by deficit countries in the periphery
- The latter are forced to go through “internal devaluation”, i.e. reducing domestic wages and prices, without a compensating force coming from surplus countries allowing wages and prices to increase
- Some symmetry in the adjustment mechanism would alleviate the pain in the deficit countries.

Symmetric macroeconomic policies

- Stimulus in the North, where spending is below production (current account surplus)
- Austerity in the South (but spread out over more years)
- This also allows the monetary union to deal with current account imbalances. It takes two to tango
- Symmetry in policies is key: it avoids deflationary spiral in the South
- European Commission does not do this in the implementation of “Macroeconomic Imbalance Procedure”

(3) Fiscal Union

- Some form of pooling of government debts is necessary to overcome fragility of Eurozone.
- By pooling government debts, one shields the weakest in the union from destructive movements of fear and panic that regularly arise in financial markets.
- Of course, not any type of pooling of national debts is acceptable.
- Main problem: moral hazard

Three principles for optimal design debt pooling

1. It should be partial,
 - A significant part of the debt must remain the responsibility of national governments, to give them a continuing incentive to reduce debts and deficits
 - Bruegel proposal and German Debt Redemption plan
2. The internal transfer mechanism between members of the pool must ensure that the less creditworthy countries compensate (at least partially) the more creditworthy ones
3. There should be a tight control mechanism on the progress of national governments in achieving sustainable debt levels

Conclusion

- Eurozone is in the midst of an existential crisis that slowly but inexorably destroys its foundations.
- The only way to stop the existential fears is to convince the financial markets that the Eurozone is here to stay.
- A debt pooling that satisfies these principles gives a signal to the markets that the member countries of the Eurozone are serious in their intention to stick together.
- Without this signal, markets will not quiet down and an end of the euro is inevitable.