EURO

Doomed to Failure?

By Remy Piwowarski & Ethan Lutske

Overview

- What is the European Union?
- History of the European Integration
- Brussels-Frankfurt Consensus vs. Mundel
- Quantitative Data
- The Future of Euro (possible break-up?)
- Euro and Central-Eastern Europe

Two points:

- Discussion after every issue
- Feel free to ask questions!

Let’s start!

This is Europe…

Apologies… This is Europe…

Europe is not the EU, though…

What is the EU?

An international organization with no equivalent in history or in the modern world.

European Integration in a Nutshell

- 9 May 1950 – Robert Schumann proposes the establishment of a European Steel and Coal Community **(**Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and the Netherlands as members).
- 25 March 1957 **European Economic Community is formed.**

(customs duties between the six countries are abolished on 1 July 1968)

- 1957 - The **European Atomic Energy Community** is created
- 1973 - Denmark, Ireland and the United Kingdom join the Community..
- June 1979 - the **first elections to the European Parliament**
- 1980s – **Greece (1981)**, **Spain and Portugal** (both: 1986) join the European Community..
- 1992– Maastricht Treaty forms the European Union.
- 1995 - Austria, Finland and Sweden join the EU
- 1999 – introduction of the euro in financial transactions
- 2002 – 12 countries adopt euro as its currency
- 1 May 2004 - the Czech Republic, Hungary, Poland, Slovakia, Estonia, Latvia, Lithuania, Slovenia, Cyprus and Malta join the EU.
- 2007 – Bulgaria and Romania join the EU

Three Pillars:

EUROPEAN COMMUNITIES

- Common Market (including regulations)
- Economic cohesion policy
- Common Agricultural Policy
- Innovation Policy
- Competition Policy

CO-OPERATION IN CRIMINAL MATTERS

- Justice and legal affairs (extraditions, fighting organized crime etc)
- Asylum and immigration

FOREIGN POLICY, DEFENSE AND SECURITY

- Cooperation in peacekeeping operations
- Coordination of foreign policy

Main institutions:

- The **Council of Ministers of the European Union – the main EU legislative body**. Its main task is to represent member states
- The **European Parliament -** exercises legislative and budgetary powers with the Council of the European Union, represents the people.
- The **European Commission -** the main executive body. It proposes new legislation and bears responsibility for policy implementation. It is tasked with protection of common interest of the EU

The Genesis of the EURO

- 1970s. The collapse of the Bretton Woods system takes place. The European countries make a special aggreement on maintaining stable exchange rates (band 2.25%).

- 1979, the system is disbanded. The European Monetary System and the European Exchange Rate Mechanism (ERM-I) are created. Fixed exchange rates are maintained between currencies of 8 European countries. The central role is played by a highly-stable Deutschemark.

- Early 1990s – pressures on the European exchange system induced by the reunification of Germany.

EMS Crisis 1992

- After the reunification of Germany; demand pressure causes the inflation in Germany to go up
- Bundesbank tightens monetary policy
- Tight monetary policy is inappropriate for the rest of Europe (esp. the UK), which is in a recession
- Rumours of devaluation lead to a pan-European currency crisis

Policymakers face the question:

What to do now?

The Intensification of Works on EURO

- 1988 – EC countries want a common currency – Delors Commission prepares a 3-stage plan
- 1990 – **Stage I** – abolition of exchange controls
- 1992 – Treaty of Maastricht – the treaty precised the conditions of the adoption of the Euro later know as the Stability and Growth Pact
- 1994 - **Stage II** – maintaining currency parities
- 1999 – **Stage III** started introduction of the Euro in financial transactions
- 2002 – 12 EU countries adopt euro as its currency

Optimal Currency Areas: Symmetry, Flexibility…Integration?

- Think of these two variables as goods on a budget
- It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility.
- What does integration due for the OCA? Has it been implemented?

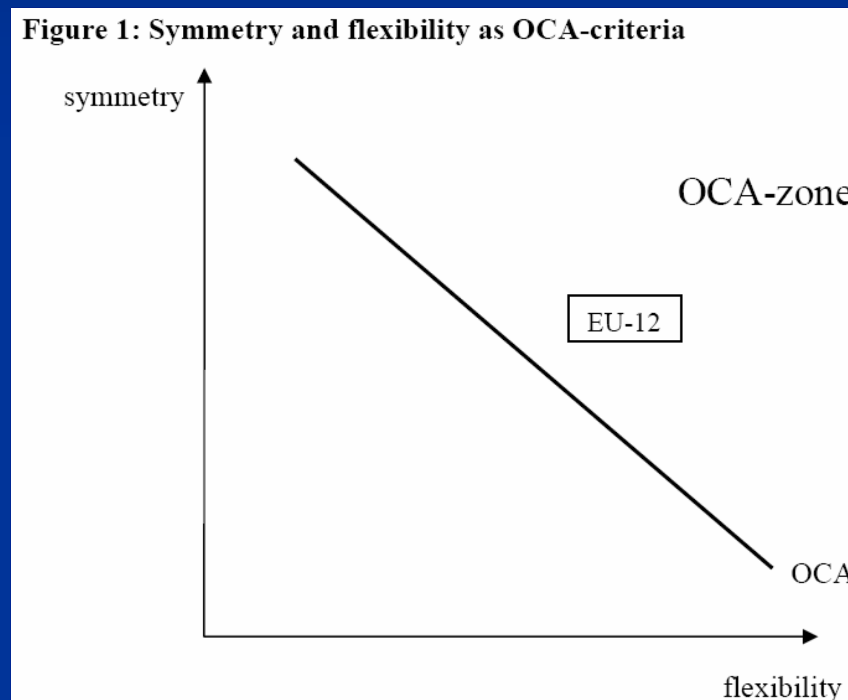
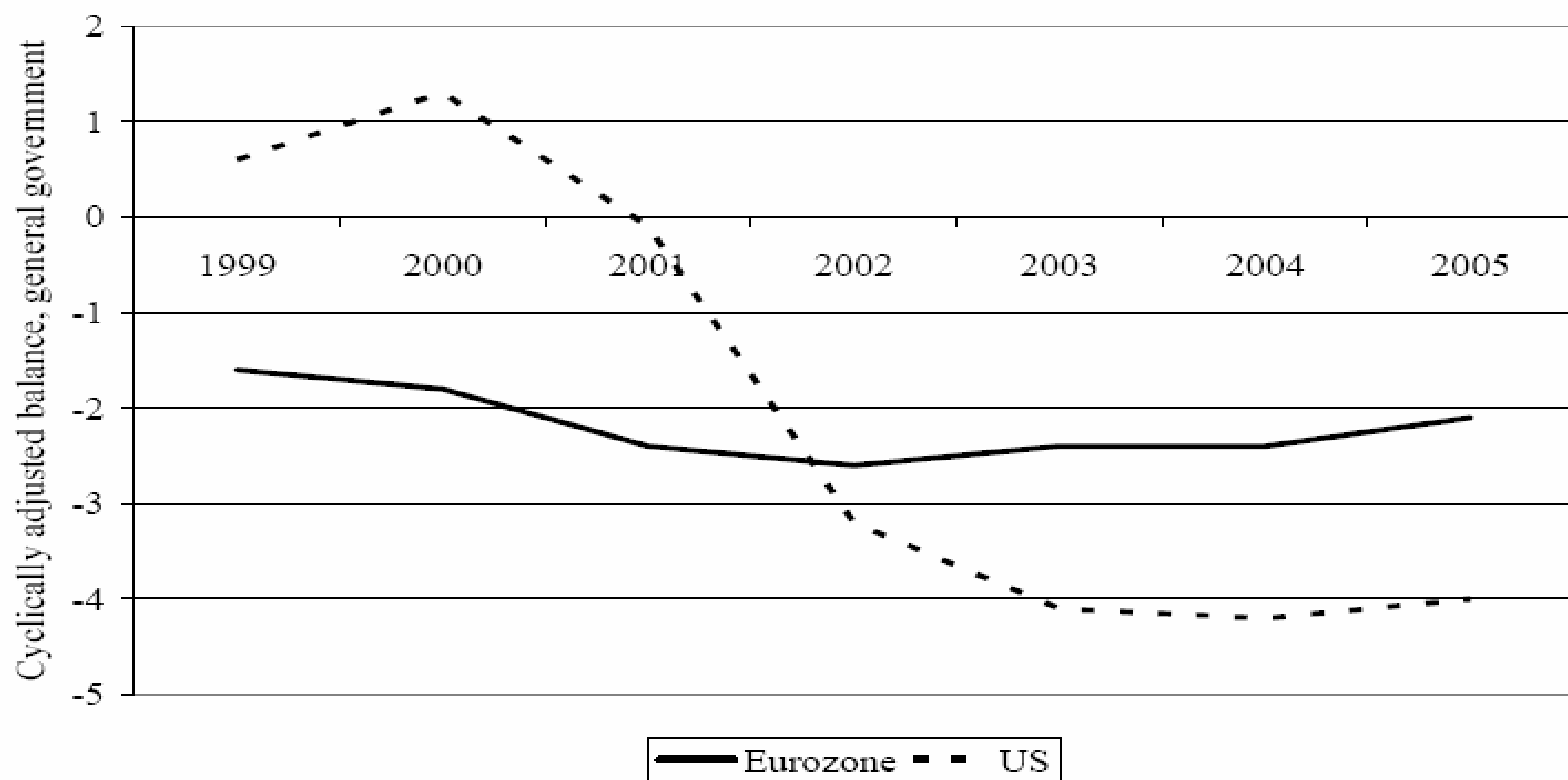


Figure 1: Symmetry and flexibility as OCA-criteria

Cyclically adjusted budget balance in the Eurozone and the US

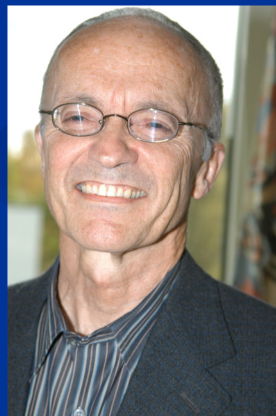


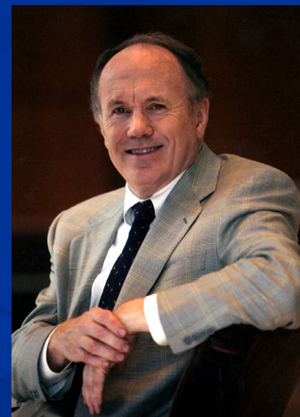
Source: European Commission.

The EU is not responding fiscally, and the economies are paying the price.

Frankfurt-Brussels Consensus

- Rational Expectations (1970s – created by Lucas and Sargent)
- Real Business Cycle (1980s – Kydland & Prescott)





Rational Expectations (1)

- individuals make their decision on the basis of current and best information about the future

- individuals do ***not*** make their predictions on irrational basis (Keynes' animal spirits), or mainly on the past experience (adaptive expectations)

Rational Expectations (2)

- Basic tenets of monetarism – monetary policy acts with long and variable lags
- Conclusion: no fine-tuning
- Only **unexpected** monetary policy can take an effect on GDP
- Expected policy can still affect inflation, though.
- Markets clear instantaneously as soon as correct information about prices is supplied to them

Credibility of a Central Bank

- Inflation=f(u) + supply shocks + **exp. inflation**
- People form their expectations on the basis of central bank's pronouncements
- People will not believe in central bank's pronouncements if the actions of the central bank were to the contrary in the past
- If a central bank bows to pressures and loosens monetary policy, it loses its credibility and people expect higher inflation in the future.
- Credibility of the central bank – policies should be stable and aimed at inflation

Real Business Cycle

- Random walk of GDP theory (GDP does not have to come to the main trend)
- Changes in GDP growth induced mainly by supply shocks (technological changes)
- Propagation mechanism – in short: lower productivity makes people work less

Brussells-Frankfurt Consensus

- Independent European Central Bank
- Inflation targeting policy
- The risk of asymmetric shocks is small
- The risk of adverse shocks may be mitigated endogenously by further economic integration
- The risk of adverse shocks can further be mitigated by STRUCTURAL REFORMS

Summary - Which View?

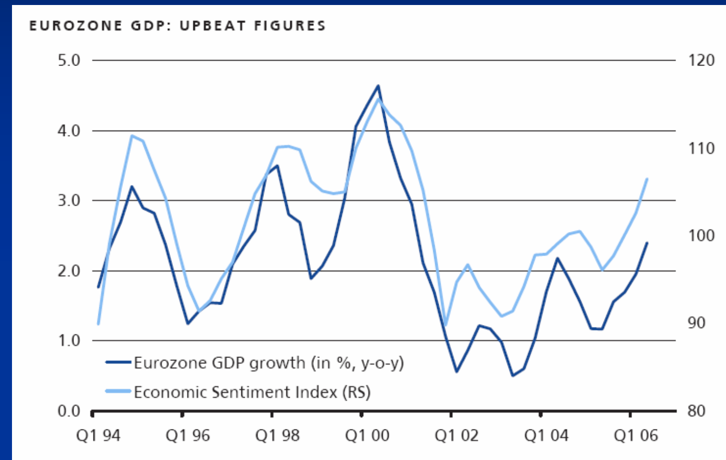
- Mundell I
  - Politics is paramount
  - Integration is the only sustainable way to coordinate fiscal policy, which is necessary to combat natural complications of a monetary union.
  - **European Superstate?**
- Brussels-Frankfurt
  - Monetarist view
  - Central Bank can control all that is necessary
  - Treaties like SGP can lead to fiscal reforms
  - **Union of Nation-states?**

What do you think?

DATA

GDP Growth

- The Eurozone has had growth over the last five years after poor growth right after the inception of the Euro
- Growth spreads across nations
- Growth is slow overall, though. Us growth rate has been 2.6%, compared to 1.7% for the Eurozone



	2005	2006 *	2006**	2007 **
Austria	1.8	2.0	2.3	2.0
Belgium	1.3	1.7	2.4	2.0
Denmark	2.0	2.1	2.7	2.3
France	1.4	1.6	2.0	2.0
Germany	0.9	1.1	1.7	1.3
Italy	0.0	0.9	1.3	1.1
Netherlands	0.6	1.6	2.2	2.1
Spain	3.3	2.9	3.3	2.8
Sweden	2.3	2.7	2.9	3.1
U.K.	1.9	2.1	2.4	2.5
Euro area	1.2	1.5	2.2	1.8

Inflation problems

- Inflation rates were brought in line before the introduction of the Euro in order to coordinate transition.
- Since then, they have seriously diverged
- Big issue for creating asymmetries, real exchange rates, and cyclical difficulties
- Over the 1999-2004 period, the range of cumulative inflation across EMU member countries was 16.5 percent, whereas the range for US regions was only 8.7 percent.
  - The problem is more persistent in the EU

Table 1: Average Annual Inflation Rates, 1999-2004

	All	Goods	Services
Euro Area	2.0	1.8	2.3
Belgium	1.9	1.7	2.1
Germany	1.4	1.3	1.4
Greece	3.2	2.9	3.8
Spain	3.0	2.7	3.8
France	1.8	1.7	1.9
Ireland	3.8	2.6	5.5
Italy	2.4	2.1	2.8
Luxembourg	2.5	2.4	2.7
Netherlands	2.8	2.4	3.4
Austria	1.6	1.1	2.2
Portugal	3.1	2.4	4.4
Finland	1.7	1.1	2.7
St.Dev	0.8	0.6	1.2
Range	2.4	1.7	4.1

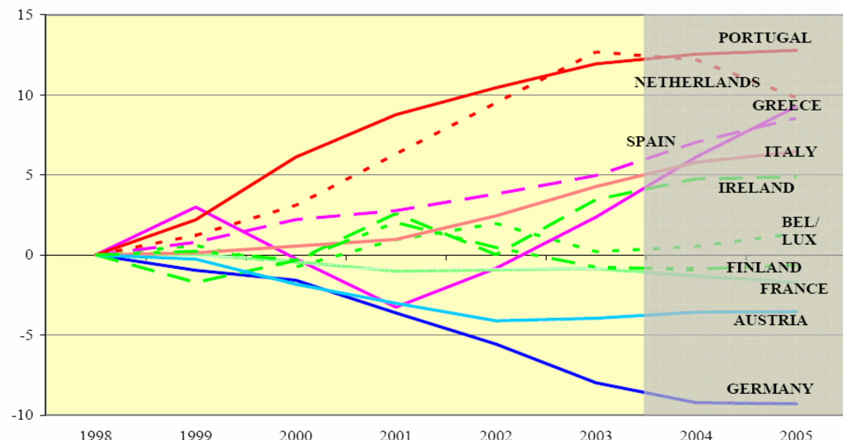
Inflation and Exchange Rates

- Prices are different
  - Even though the Eurozone is a single market, prices are different within different countries, and the competitiveness of nations within the Eurozone is very disparate
- Effect on exchange rates
  - All the Eurozone is a Single Market with no exchange rates, but with prices differing acros national lines and different inflation rates, the real exchange rates on goods is very divergent.
- The lack of a monetary fix harms both ends
  - Booming economies like Germany wants a higher interest rate, while nations like Portugal and Italy would want a lower one. Moderation provides stability on average, but not answers to inflation issues

Table 4: Evolution of National Competitiveness, 1999-2004

	Total	Intra-Euro	Extra-Euro
Germany	-1.3	-4.9	3.3
Italy	5.6	2.5	11.1
France	2.2	-1.7	8.7
Belgium	2.7	-1.1	9.4
Netherlands	8.6	4.6	14.6
Spain	9.9	6.7	17.7
Austria	-0.8	-0.6	2.9
Portugal	7.2	4.5	16.8
Ireland	16.9	10.8	21.1
Finland	-0.6	-2.1	2.3
Greece	4.4	2.9	7.9
Luxembourg	7.2	4.5	15.9

Note: Changes in National Competitiveness, 1999-2004. Source: Author's calculations, based on ECB data.



Euro and Financial Markets

- "Yield differentials across member countries fell sharply, the volume of private bond issues grew rapidly and…the market microstructure converged to a common area-wide system." (Lane, The Real Effects of the EMU)
- Outstanding stock of securities issued by corporates in the Euro area has grown from 32.2 percent of GDP at the end of 1998 to 74.5 percent of GDP by June 2005.
- Intra-Euro FDI up by 62%
- Why?
  - Pan-European view
  - More trust in currencies
  - More trust in future integration

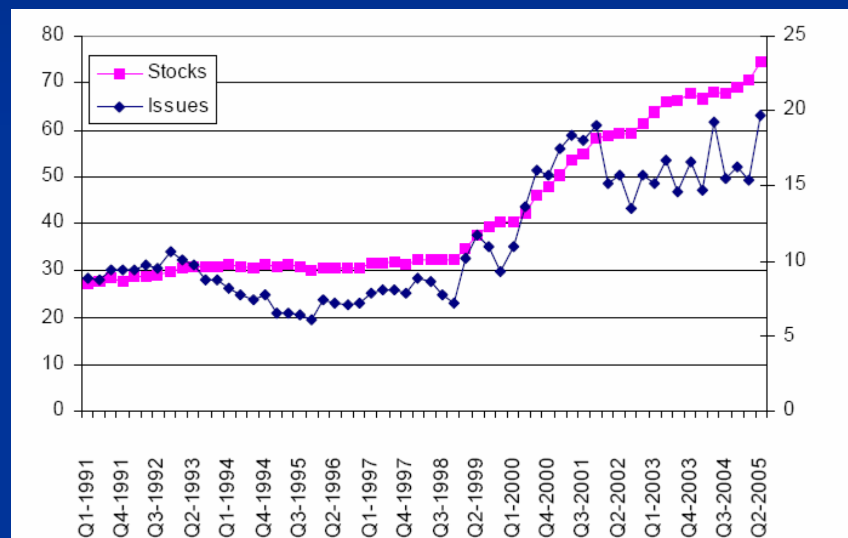


Figure 3: Corporate Securities: Outstanding Stock and New Issues, Euro Area. Expressed as a ratio to GDP. Source: Author's calculations based on ECB data.

Effects of Financial Success

- Risk diversification
- International risk hedging
  - Does this really have an impact?
- Countries can run larger current account deficits
  - Greece, Portugal, Spain
  - Good in the long run?

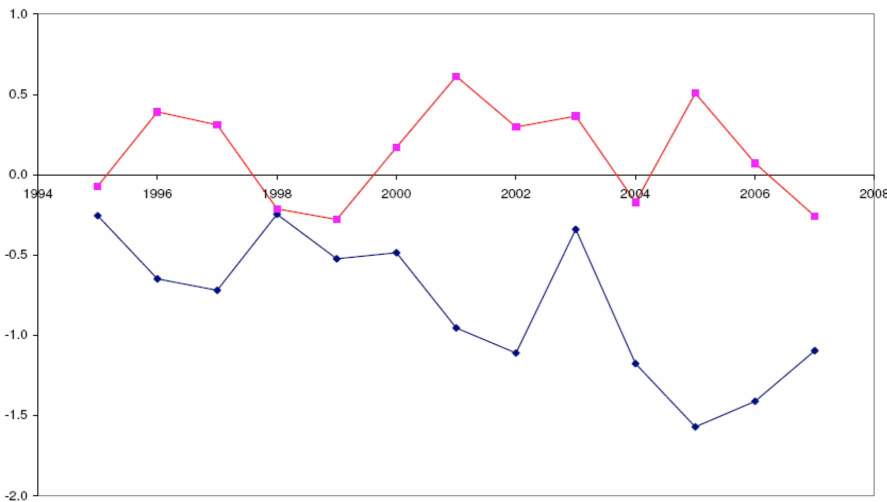
How long can this last?

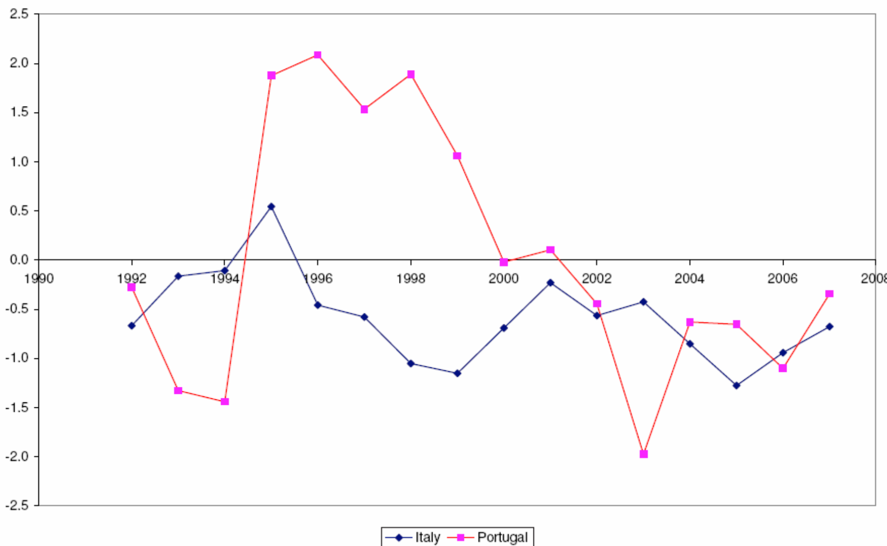
- Rates of return to investment have been falling
  - Dollar depreciation
  - Oil price increases
  - Could lead to 1970s like oil difficulties

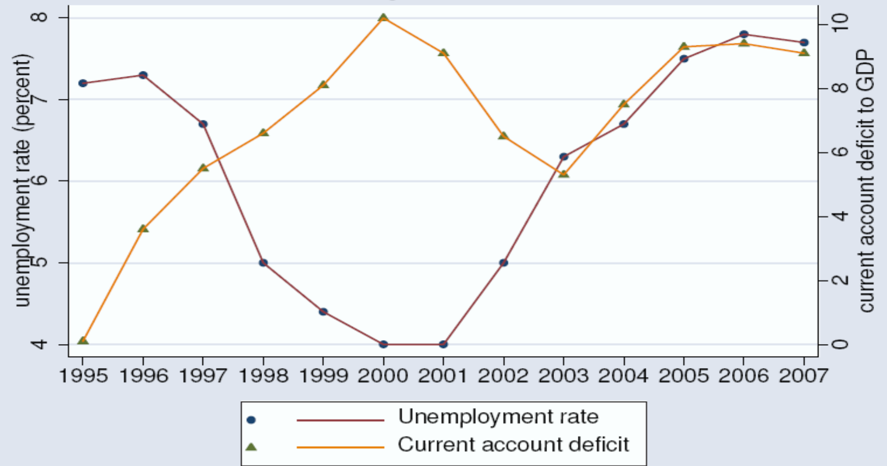
Slumps and how they work

- Euro brings credibility to places with poor price stability and high interest rates
- Bond, stock, and housing prices go up, capital flows in. Investment rises, households get richer, consumption rises
- But then the capital stock adjusts, and since the capital flow rarely boosts productivity very much, loss of competitiveness occurs
- Slow growth, high unemployment, and deflation.
- Temptation is to use monetary policy to fix the problem –but this isn't possible.

The Bounces







Slumps and the Future

- The Euro has a tendency to bounce slumps around the system as an institutional effect
- Affect countries which began at a lesser level of success and were pushed forward by the union.
- How does this affect the future of the Eurozone? Will expansion into Eastern Europe create even more of these slumps? Will entrenched EU countries like Italy and Portugal leave the Eurozone due to slump?

Brussels-Frankfurt Strikes Back… (1)

- The risk of asymmetric shocks can be mitigated by more flexibility in the labor market.
- As Blanchard (2006) argues: all countries affected by shocks have inflexible labor markets
- Flexibility reforms needed also to face the competition of emerging economies -> Euro as a good stimulus (devaluation is impossible)

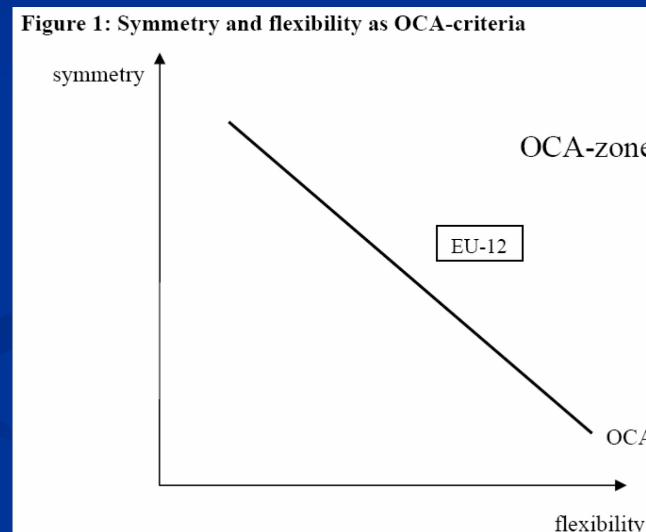


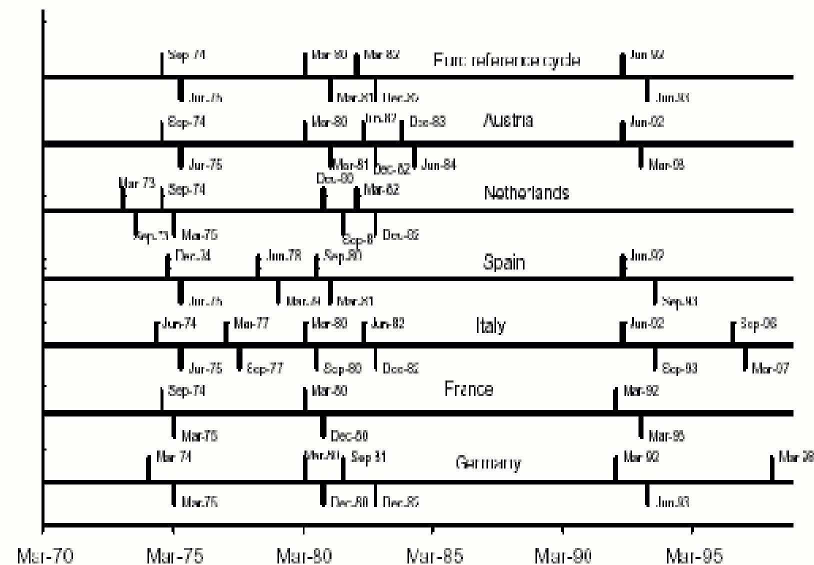
Figure 1: Symmetry and flexibility as OCA-criteria

Brussels – Frankfurt Strikes Back… (2)

- Rotating slumps are **specific** -> induced by the expectations of joining the Euro area -> in the future this may not be the case.
- Further economic integration will **endogenously** lower the risks of asymmetric shocks
- In general, there are **no wide differences** in Europe in regards to output growth (Giannone & Reichlin (2006))
- Artis, Krozlig and Toro (1999), Mansour (2003) and Del Negro and Ottrok (2003) look at long-term data and argue in favor of a **European business cycle**

GDP growth correlations and recessions

	(3) Corr(Δy_t^i, Δy_t^{EU})		
	71-03	71-89	93-03
AT	0.76	0.68	0.84
BE	0.88	0.87	0.84
FI	0.38	0.43	0.68
FR	0.91	0.90	0.93
GE	0.87	0.88	0.97
GR	0.41	0.48	-0.20
IE	0.20	0.18	0.79
IT	0.85	0.84	0.85
LU	0.62	0.70	0.70
NL	0.78	0.80	0.87
PT	0.82	0.82	0.77
SP	0.71	0.67	0.86
EU12	1.00	1.00	1.00
DE	0.54	0.56	0.62
SE	0.40	0.21	0.86
UK	0.47	0.61	0.71
EU15	0.97	0.98	0.99
US	0.51	0.61	0.54
CA	0.48	0.64	0.75
JP	0.53	0.55	-0.13
OECD	0.79	0.83	0.69



Correlations are high!

Direction:

More integration and more flexibility!

(as we can see, Jean-Claude Trichet, ECB President, is showing the direction… or maybe something else)

What do you think?

Will it collapse?

Will someone walk away?

Can the Euro Collapse?

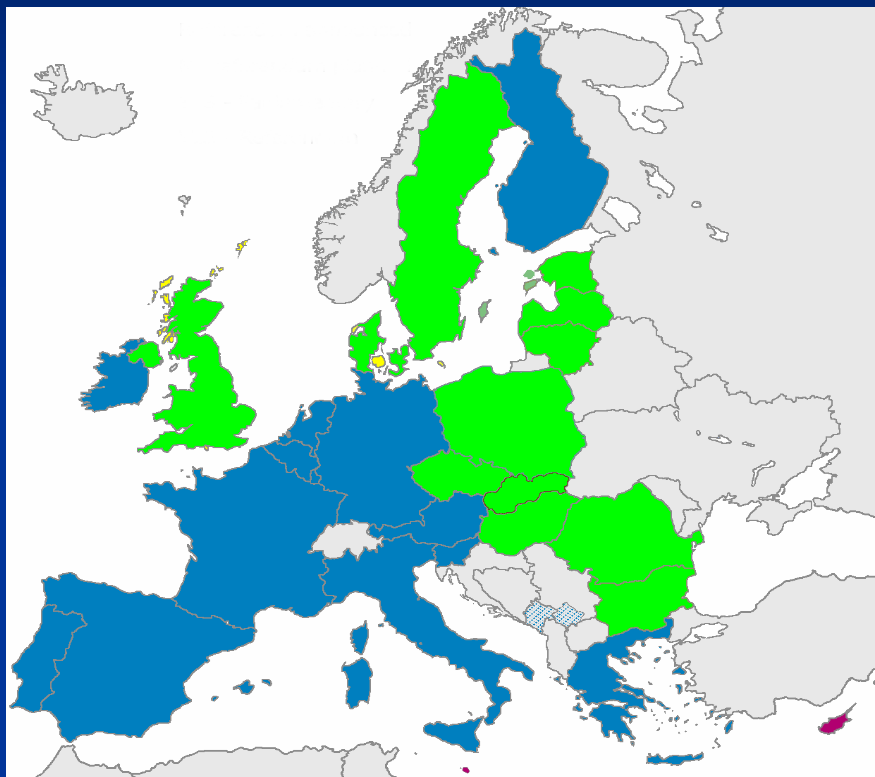
- It is possible for a system such as the Euro to fall apart. The coalition is held together by mutual goodwill. Unlike the US or another federated Union, there's no central coercive power. So why would a country leave?
- Country is being held back due to its success
  - Germany is the 5th biggest economy in the world and has been booming ever since it recovered from reunification. It wants to be able to control its own monetary policy since the price-stability model that the EMU follows doesn't let Germany live up to its full potential. Over 60% of Germans now want to return to the Deutschmark, and recently a French poll revealed over 50% of that populace wants to return to the Franc.
- Country is being held down and flailing
  - These are the slump nations, like Portugal and Italy. They are being hindered by having their national currencies worth more than would be natural. They would want to return to their Escudo or Lira, devalue their currencies, and thus boost exports.

Difficulties to breaking away

- Institutional
  - The nation would have to physically replace all ATMs, signs, banking apparatus, etc. This was achieved in order to institute the Euro in a 3-month span due to intense cooperation and will. Will it be doable for a single nation to return to their own currency?
- Economic
  - Re-pricing of all goods, reforming the banking sector, re-establishing independent financial markets. These are just some of the possible economic issues for returning to a national currency.
  - No guarantee that a return to national currency would alleviate any problems.
- Political
  - Any nations which leaves the Euro system would be looked at quite disparagingly by the nations they are abandoning. The nation that leaves would still be part of the EU and the Single Market, but would have much less ability to affect policy.
  - It's never a good idea to make enemies, and if leaving caused a chain reaction which significantly damaged the Eurozone, the repercussions could be long and disastrous.

What do you think?

Central-Eastern Europe



- So far only Slovenia has euro as its currency (adopted on the 1st of January 2007)

Differences (according to Susan Shadler, IMF senior expert)

- High capital inflows (reversal and contagion)
- Balassa – Samuelson effects – adjustment impossible through exchange rates, so adjustment leads to higher inflation (1-2% more)
- High budget deficits
- Reforms in financial systems may be insufficient

Conclusion: to join the Euroarea Central-Eastern European countries should improve financial supervision, make competition robust and decrease deficits

To join or not to join?

Gains:

1. Elimination of currency exchange risks.
2. More price transparency – greater efficiency
3. The elimination of the emerging market risks

Costs:

1. The loss of control over monetary policy
2. The likeliness of a currency crisis while staying in the ERM II

The most important:

“Conservative fiscal policy and low inflation is what every Central – European country needs”
Susan Shadler

vs.

The risk of assymetric shocks and rotating slumps (Blanchard’s paper)

Lack of political support?

PRO-EURO

AGAINST EURO

One more danger?

- The European Superstate would inevitably (?) mean the synchronisation of taxes and social security policies.
- Liberal reformers in the Eastern Europe are afraid that it would mean equalising taxes in Central – Eastern Europe to the level of Western Europe and possibly the slowdown of structural changes in the labour market-> that may lead to the loss of FDI competiveness
- Frankfurt-Brussels Consensus may be a better option for Central-Eastern European countries (?).

What do you think?

endless end, video, 2004

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