



The Euro @20: Economic Challenges and the role of the ECB

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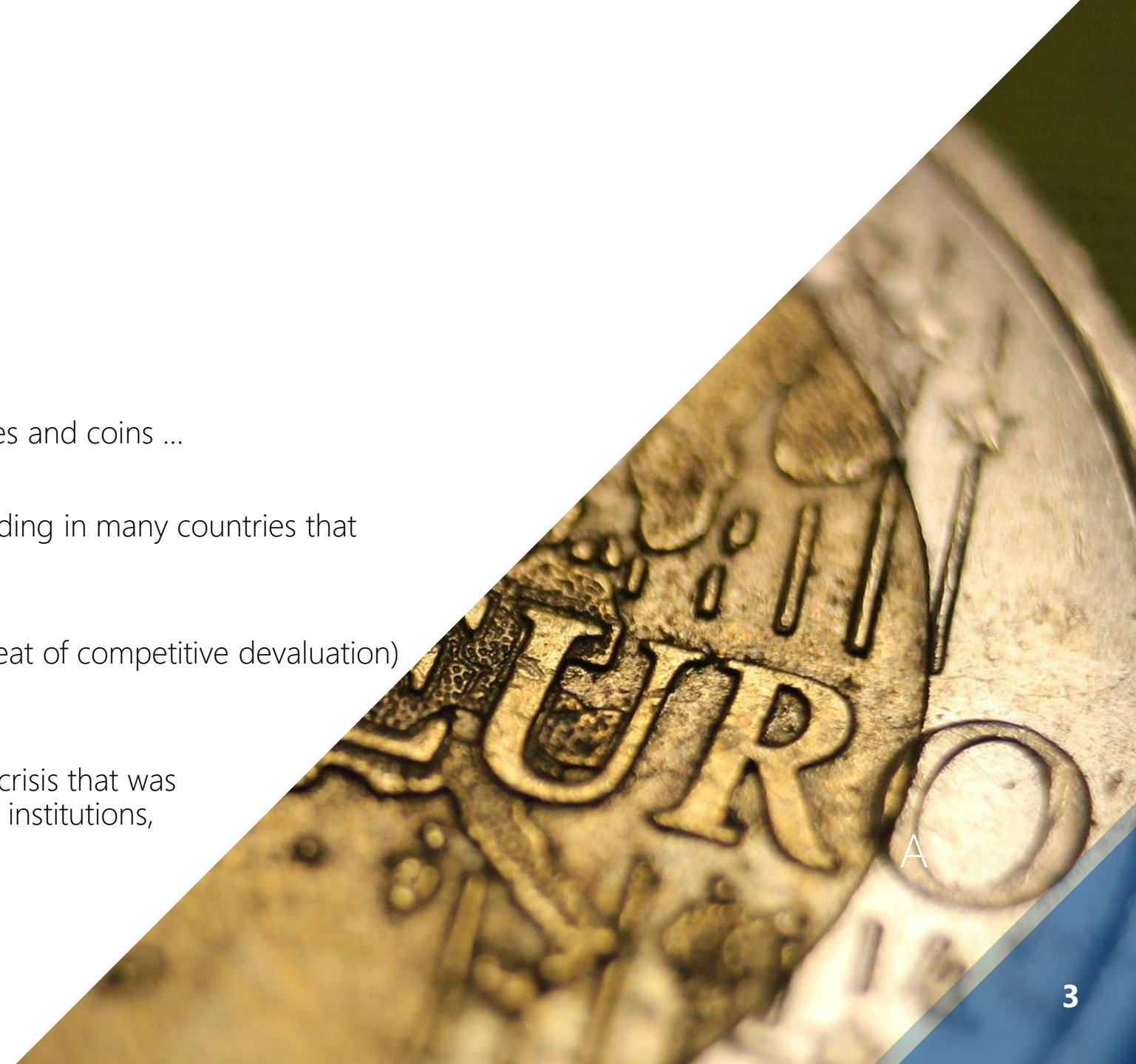
Motivation and key messages

- ◆ For currency unions, “20 is the new 50”: time for stock taking, self questioning, drawing lessons, committing to fitness, and hoping for eternal health
- ◆ The euro is 20! What did we learn about the **economic challenges facing the Euro Area, and the work of the ECB?**
- ◆ I will briefly make 3 points to kick off our discussion:
 1. US economists were wrong: the euro did not cause war, it is a **qualified success!**
 2. The 2008 Global Financial Crisis (GFC) revealed well-known birth defects that we know how to address, as the response to GFC shows
 3. The ECB has mostly done its part ... but it cannot be alone doing the heavy lifting
→ reforms needed

A success ...

◆ Key achievements of the euro:

- ◆ Go from Finland to Malta using the same notes and coins ...
- ◆ Delivered (too?) low and stable inflation, including in many countries that rarely experienced price stability before
- ◆ Made the single market more resilient (no threat of competitive devaluation)
→ *One Market, One Money* mantra
- ◆ Survived an **epic** banking/financial/sovereign crisis that was predicted to be lethal → EA governments, EU institutions, and the ECB proved surprisingly agile



... but a qualified one due to known flaws

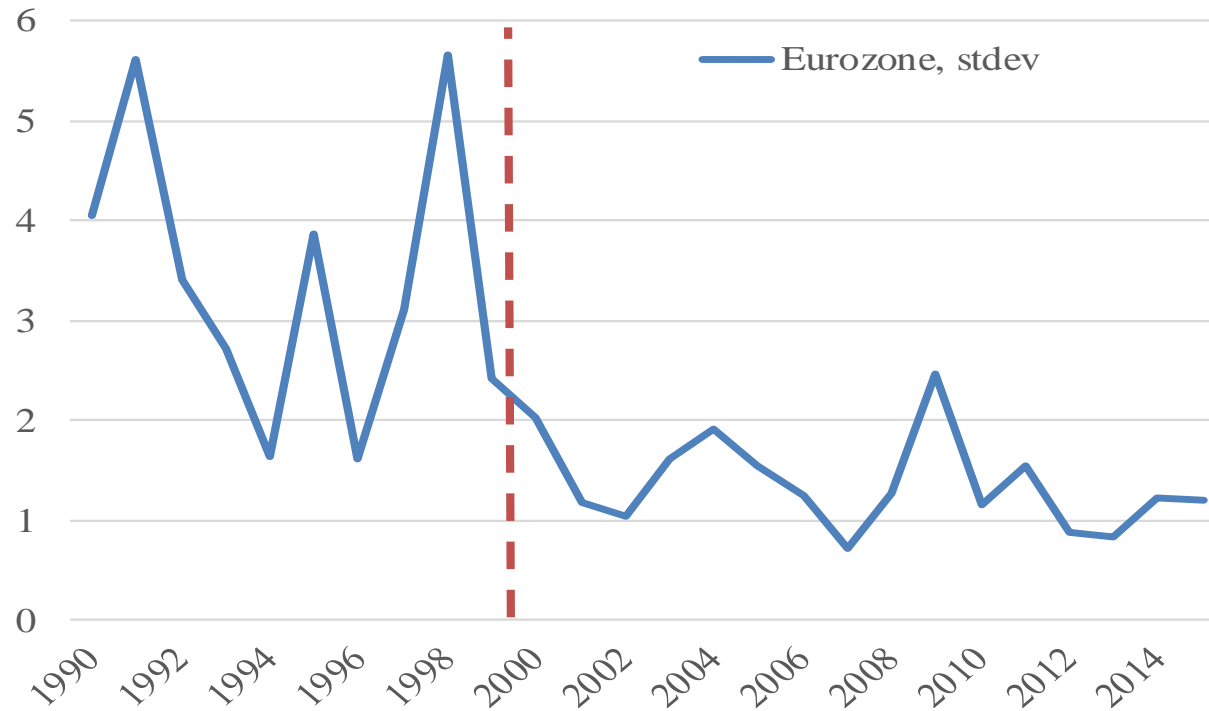
- ◆ The GFC exposed **birth defects** known from the beginning (but sometimes neglected):
 - ◇ The euro area is still far from an optimum currency area (OCA)
 - ◇ The institutional architecture is incomplete
 - ◇ Euro Area members are not immune from classic BoP crises (Greece, Ireland, Portugal)
- ◆ There was **political overreach** about what the euro could achieve:
 - ◇ Monetary union did not become the stepping stone of political integration
 - ◇ Euro did not rival US\$ as reserve currency, unlike some would have hoped
 - ◇ “Convergence” was oversold

Not an Optimum Currency Area

Shocks were **less asymmetric** than before ...

Lower (median) volatility in terms-of-trade

(in %)

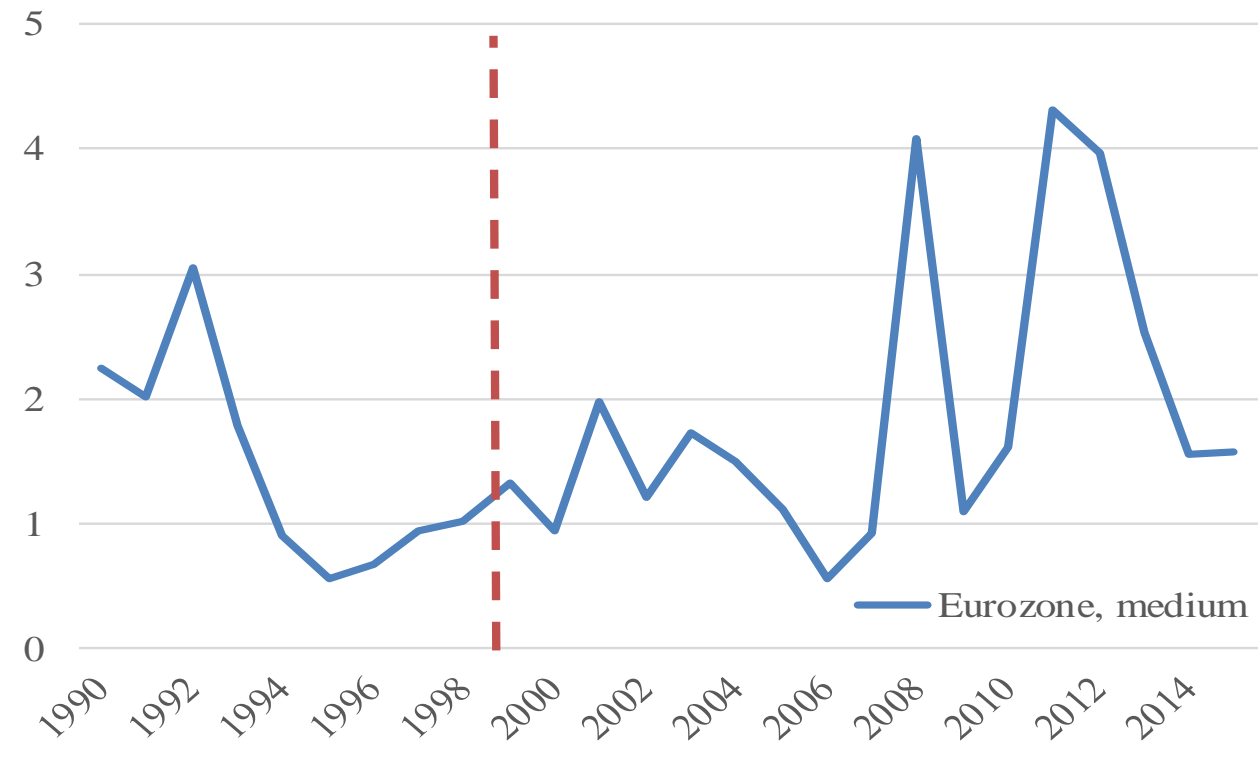


Not an Optimum Currency Area

But not enough to make the single monetary policy right for all ...

Median absolute deviation from country-specific "Taylor rules"

(in %)



Incomplete architecture

- ◆ **No political/fiscal union:** in a currency union, every national government should act in a fiscally responsible fashion and issue “safe” assets ... one single weak link can cause spillovers
 - ◇ **Fiscal rules failed** to achieve uniform fiscal discipline → widespread debt overhang
- ◆ **No full banking union, no single safe asset, and weak capital market integration:** insufficient risk sharing through markets, home bias and “doom loop”
 - ◇ Progress towards banking union (central bank supervision by ECB, second pillar resolution...) but plans for only limited fiscal backstop (resolution, deposit insurance) by fear of **moral hazard?**
- ◆ **Weak incentives to carry out structural reforms**
 - ◇ **Theory:** euro means higher costs to policy mistakes → fewer mistakes
 - ◇ **Reality:** mistakes are just more costly!
 - ◇ **Center’s efforts to encourage reforms:** “Lisbon” European Semester, contingent fiscal rules to make the EU the most competitive economy in the world ... Not quite there (yet)!

Balance of payment crises

- ◆ The naive pre-euro belief that intra-area imbalances were irrelevant turned out to be wrong
Living in EA is as if every country borrowed only in foreign currency and without LOLR
Crises can occur, be contagious, self-fulfilling, and... existential for the union
 - ◇ Crisis management tools were set up (ESM of 500 billion €) → LOLR
 - ◇ Prevention of self-fulfilling crisis: ECB's promise to do "whatever it takes"
- ◆ Markets never believed in the no-bail out clause:
 - ◇ Crisis prevention and management apparatus institutionalized bailout
 - ◇ Hard to rely on market discipline to tame fiscal profligacy
 - ◇ Central (EC) interference with national fiscal sovereignty needed to mitigate moral hazard
 - ◇ All this encourages scapegoating of EU and feeds populism in both 'North' and 'South'

Political overreach

Some hoped to build European federalism/political union by stealth:

- ◇ Start with **technocratic steps** ("it's good economics, stupid!"):
 - Single Act of 1986 creates a **single market** by 1992 → Single market cannot deliver fully (or even survive) if competitive devaluations are possible and cross-border financial transactions are restricted → **fixed exchange rates with free capital mobility**
 - The trilemma strikes with a vengeance. FX crises of 1992-93 broke the EMS (first Brexit: BoE out of the System,...) → **Monetary union** is the only credible way (*One Market, One Money*)
- ◇ **Tipping point**: a monetary union without a political union is fragile. So political integration should 'crown' monetary integration! It did not happen (yet)
- ◇ **Good economics ('a border is costly') ≠ good politics (a border defines 'our' space)**
 - People were told that the euro was going to **benefit consumers** (and, yes, that they would need to become more flexible ...)
 - They were not informed that, in fact, they had decided to go for the United States of Europe ... and that, according to many (economists), they do not really have the choice anymore

Political overreach

- ◆ Although not an official goal, some would like to see € play an international role challenging \$
- ◆ True, EA is a large and financially developed economy
- ◆ But:
 - ◇ No **fully** integrated capital markets or banking system,
 - ◇ EA cannot offer a large pool of safe assets → US T-bill market remains unparalleled in terms of safety and depth/liquidity, keeping the dollar as the reserve currency par excellence
 - ◇ ECB benign neglect: international role of the euro is just the result from stable macro-economic policy and the missing elements above, not a deliberate action

Political overreach

- ◆ The promise of living-standards (sigma) **convergence** was (inevitably) broken
- ◆ Indeed, the Euro per se could not be expected to guarantee convergence (be it real, nominal or fiscal):
 - ◆ **In fact**, convergence does not even exist across regions of countries that have both a single currency AND elaborate fiscal federalism systems (transfers, etc)
 - ◆ **In macro theory (Solow)**, convergence only occurs under implausible conditions (e.g. integrated capital markets, similar preferences across countries, no friction)
 - ◆ **In trade theory**, convergence occurs in relative factor prices, and again under implausible conditions (e.g. perfect competition)
 - ◆ **Asymmetric shocks entail diverging inflation rates and fiscal policies**: higher inflation (lower fiscal deficits) in booming countries, lower inflation or deflation (higher deficits) in contracting economies
- ◆ But convergence is seen as important:
 - ◆ **Politically**: original selling point in *One Market, One Money*, and requirement to join EA
 - ◆ **Economically**: the structural factors hindering living-standards convergence contribute to temporary divergences that bring countries further away from the OCA ideal

Stalled convergence?

GFC stirred fears that convergence would stall permanently

Did not happen as relative prices still adjust between countries → we did not 'lose the south'

But **real** adjustments are much more painful than when **nominal** exchange rates could do the job quickly



The role of the ECB

- ◆ After initial hesitations, the ECB did not waste the GFC and matured:
 - ◆ It fully assumed a normal **LOLR role**, preserving the stability of the banking sector through ample liquidity provision. It is now at the center of banking supervision
 - ◆ It **prevented self-fulfilling sovereign debt crises** that could have destroyed the euro
 - ◆ It **enriched its set of instruments** (QE, forward guidance, ...) to mitigate deflation risks and keep inflation expectations anchored
- ◆ Today's more agile ECB is a welcome legacy of the crisis

The role of the ECB

◆ Should it do more? Yes according to some academics and pundits ...

1. Less-nation-centric governance
2. Actively coordinate with fiscal policy to reflate the economy (helicopter money, fiscal dominance, debt monetization)

◆ My take:

1. Large deviations from the one-country-one-vote principle would raise toxic legitimacy issues. So far, good balance between national legitimacy and the common good, although occasional tensions arise
2. On a joint monetary-fiscal blitz, I am a really open guy, but I am not crazy!
 - ❑ Too many Pandora's boxes open → the mother of all **moral hazards**
 - ❑ **Intractable exit issues** → how do you "recommit" debt addicts to financial sanity after luring them into an indefinite borrowing spree? On the fiscal side, "whatever it takes if needed" could too easily be understood as "whatever you want any time." → when commitments cannot be taken at face value, coordination can be counterproductive

Looking forward

- ◆ The Euro Area is much more resilient today than it was in 2008 largely thanks to the emergence of LOLR tools and ECB pragmatism and agility
- ◆ In the laundry list of systemic reforms, prioritization is in order → 4 buckets of reforms
 - ◇ **Existential but always challenging:** Make all government bonds safe → simpler/better fiscal rules, more credible enforcement, well-designed escape clauses. We have tried since 1992... Two reforms later (2005 and 2010), that remains a challenge
 - ◇ **Essential and in progress:** break doom loops; complete banking union, CMU, reduce home bias in sovereign holdings
 - ◇ **Potentially useful but probably undoable:** More rules-based crisis management → European Monetary Fund as LOLR; sovereign bankruptcy mechanism? In practice, challenging to solve inherently political problems with ex-ante rules ...
 - ◇ **Potentially counterproductive and undoable:** Common bonds → Intractable moral-hazard vs. insurance trade-off
 - ◇ **Unnecessary ornaments:**
 - **Central fiscal capacity:** fraught with technical issues and too small to matter
 - **European Finance Minister:** to do what if no serious budget or sovereignty transfer?
 - **European unemployment reinsurance:** Advice from Belgium → do not mess with incentives!