The Euro at 20: Successes, Problems, Progress and Threats

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Presentation at Dublin Economics Workshop
September 13, 2019

Plan for this Talk

Successes

Problems

Anticipated

Not anticipated (by many …)

Progress

Made

And not yet made

The Future

Resilience

Threats

Motivations for the Euro

EMU was always controversial.

- Many (particularly US-based) predicted it would not work.

But worth remembering the motivations:

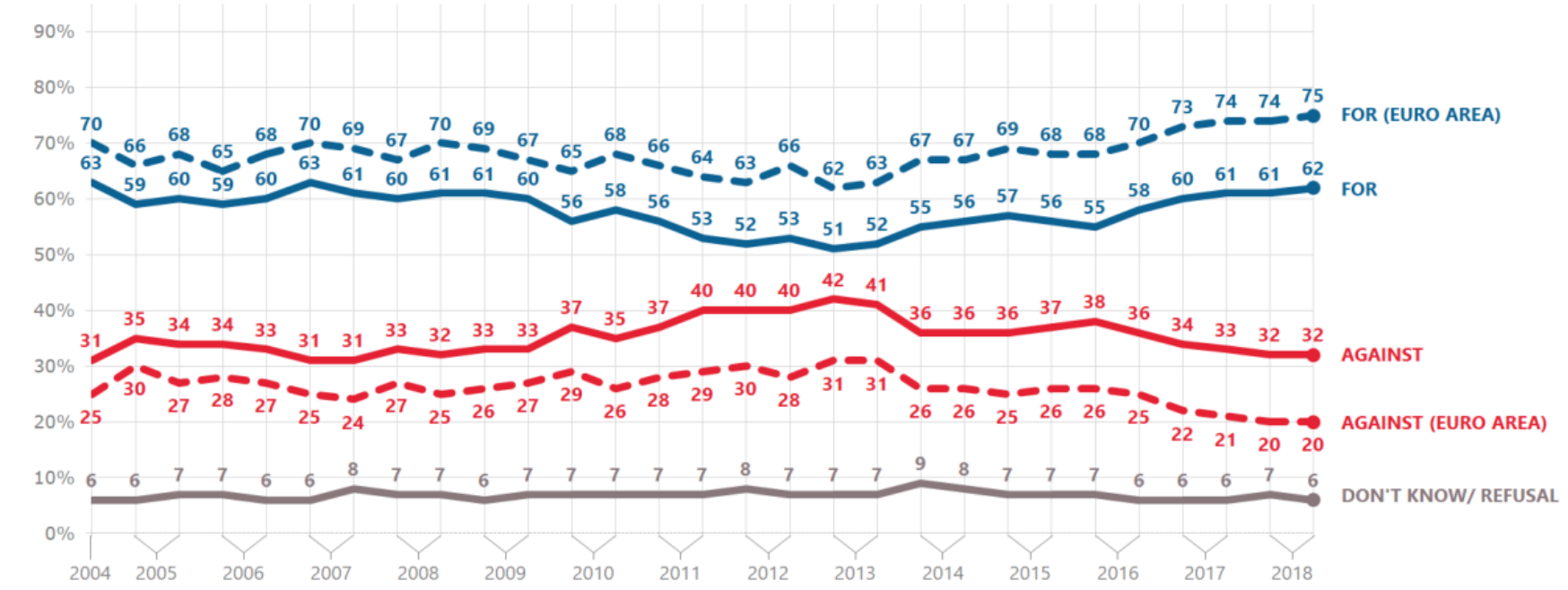
- Exchange Rate Stability: Increasingly impossible within EU with free capital movement.
- Low Inflation: The desire for a credible European-wide central bank delivering low inflation.

Against these motivations, the Euro has been a success.

“Impeccable” Price Stability: HICP Inflation

And the Euro is Very Popular

QA15.1 What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it.
A European economic and monetary union with one single currency, the euro (% - EU)



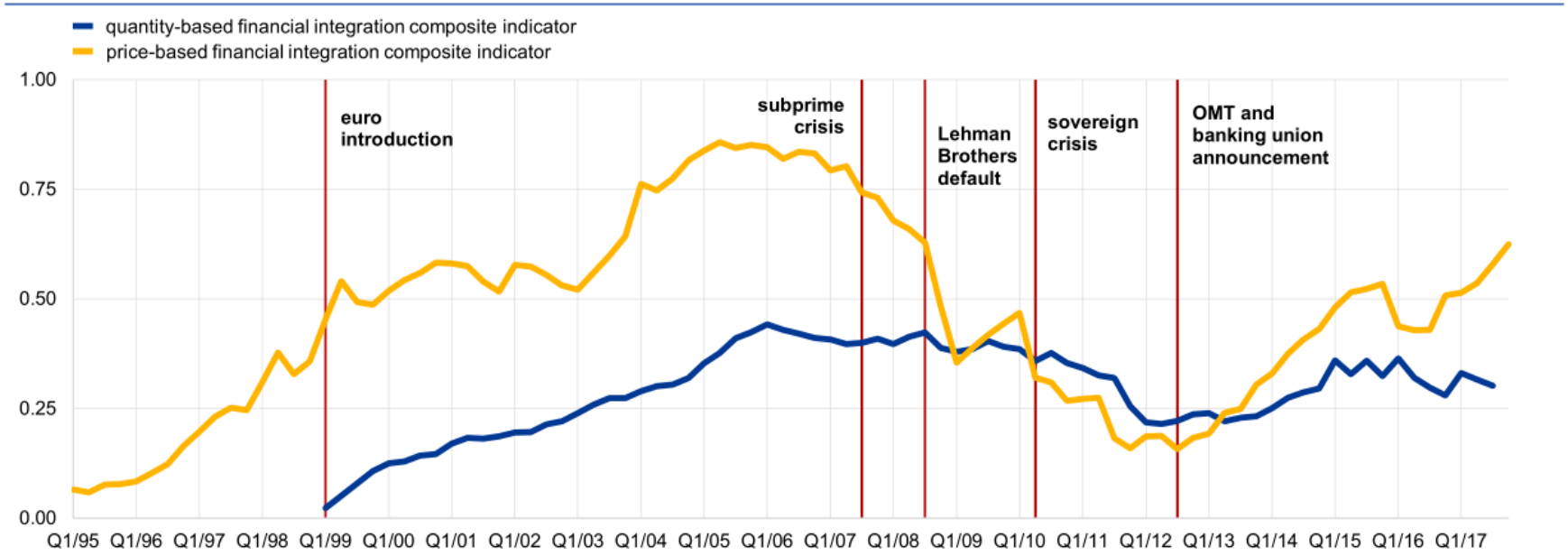
Mixed Progress in Other Areas

The "One Market, One Money" benefits have been small.

Elimination of exchange rate instability does not seem to have boosted intra-EZ trade (Glick and Rose, 2016).

Movement towards development of euro area financial integration reversed during the crisis but seems to have picked up again.

ECB's Measures of Financial Integration



Problems

Fiscal Policy and Slow Macroeconomic Adjustment

Sovereign Default

Financial Stability

Economic Performance

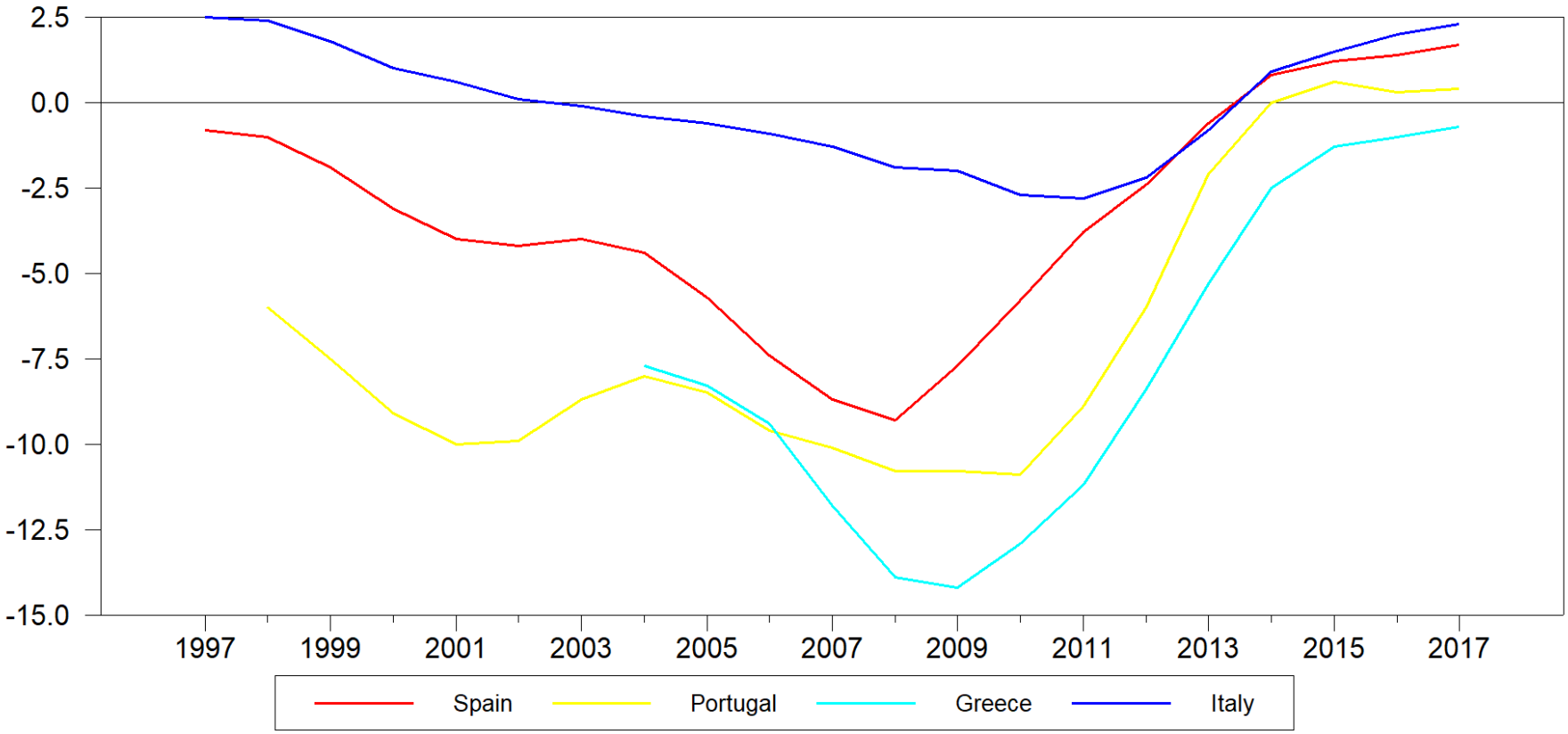
Fiscal Policy and Slow Macroeconomic Adjustment

Without exchange rate adjustment and no national monetary policies, widely understood that fiscal adjustment needed to play a bigger role.

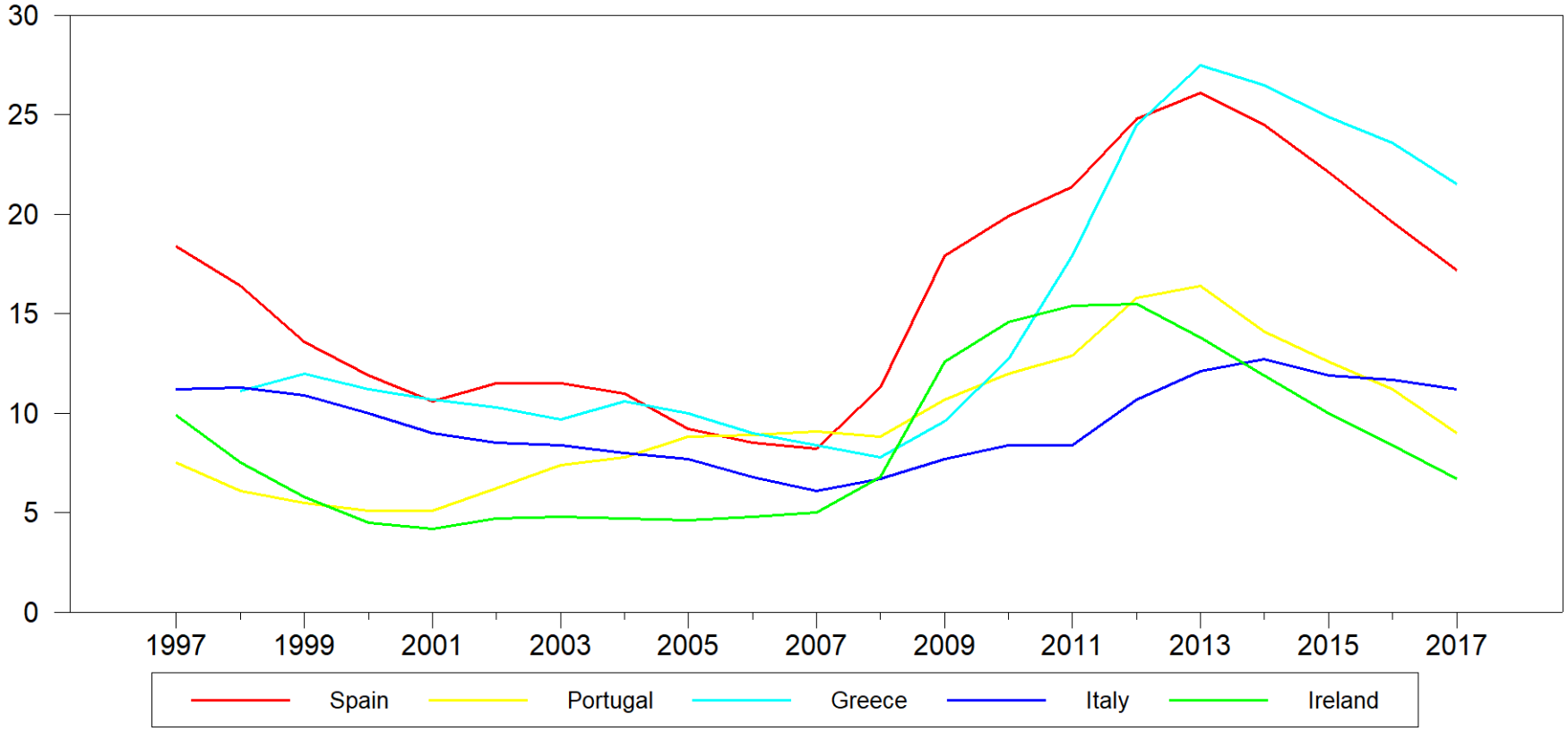
Hopes that the SGP would result in more fiscal space during recessions were not well founded.

The result is very slow adjustments of current accounts and unemployment rates.

Current Account Deficits in Selected Euro Area Countries



Unemployment Rates in Selected Euro Area Countries



Sovereign Default

Euro membership means

- No exchange rate devaluation
- Low inflation
- No restrictions on capital

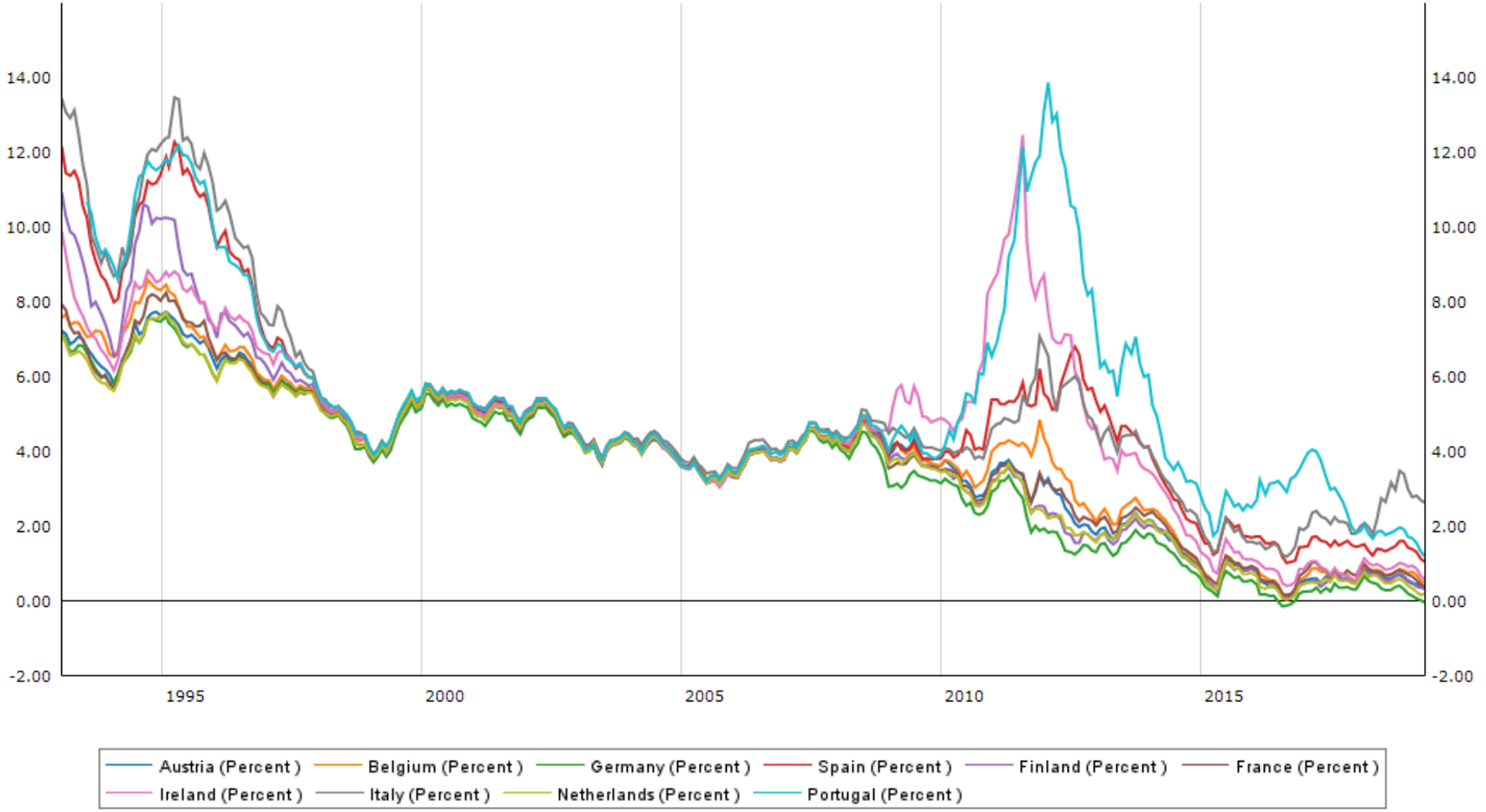
So sovereign default should have been expected as part of EMU.

However, neither markets nor policy-makers understood this.

- Markets celebrated absence of devaluation. Forgot the role this played as a safety valve for public debt.
- Policy makers forgot that first-world countries can default too. Almunia: "*No, Greece will not default. Please. In the euro area, the default does not exist*.

Crisis driven by slow dawning of the need for default inside the euro.

Yields on Long-Term Government Bonds for Selected Euro Area Counties



Financial Instability

Big debate prior to EMU about whether it would mean fewer asymmetric shocks.

Ironically, the reduction in risk spreads due to EMU turned out to be a huge asymmetric shock.

Absence of devaluation risk sent large capital flows into periphery, leading to property bubbles and over-leveraged banks.

Once markets rediscovered risk, the euro countries were particularly vulnerable to systemic banking pressures.

Bank\sovereign doom loop a big part of the crisis in Greece, Ireland, Spain, Cyprus.

Weak Economic Performance

Economic performance of the Euro Area has been disappointing.

- Average growth over 1989-1999: 2.17%
- Average growth over 1999-2017: 1.37%

Little evidence for microeconomic supply-side effects from the single currency or financial integration.

Mainly a supply-side issue but ECB's demand management has been questionable.

Progress Made

Monetary Policy

- With reluctance, ECB has gone further than any other CBs in introducing new tools.

Macroeconomic and Financial Monitoring

- Macroeconomic Imbalance Procedure (MIP) an improvement.
- Wider acknowledgement of the need for macro-prudential policies.

Progress Made

Crisis Management

- Creation of the European Stabilisation Mechanism
- Acceptance that sovereign default is part of the crisis resolution toolkit in the Euro Area

Banking

- ECB as single supervisor an important step forward for trust and transparency
- BRRD provides tools for bank restructuring and resolution while minimising fiscal cost

Progress Not Made

Fiscal Rules

- Still a mess

Joint Fiscal Capacity

- A particularly hot political potato
- Very modest Franco-German proposal to use a Eurozone budget for some national stabilisation was rejected last December.
- *"The need for such a budget is less than convincing. It is unclear how this will help, and why this would be in the interest of Dutch citizens. If this is not in the interest of the Netherlands or the Dutch taxpayer, then we are out"* Wopke Hoekstra, Dutch Finance Minister.

Progress Not Made

Sovereign Debt Restructuring

- Greek deal too generous to holdouts
- Ideally ESM could legally restructure private debt, via maturity extensions, as a condition of providing a financial support package

Banking: Bonds and Deposit Insurance

- Still have zero risk weight for sovereign bonds
- Should encourage banks to NOT hold the bonds issued by their own government.

Progress Not Made

Lender of Last Resort

- Guidelines for providing ELA to banks are ad hoc and unnecessarily complex
- Examples of large amounts of ELA provided to insolvent banks
- Banco Popular case raises questions about the meaning of “likely to fail” and the reasons for not providing ELA

Resilience

The euro has survived crises that some would have thought would cause its demise. Why?

Fear factor

- Even if joining was a mistake, that doesn't make leaving a good idea.

Political popularity

- Even populist nationalist parties are increasingly backing away from supporting euro exit.

Threats

Recession

- Future banking crises or decades long slumps may end the popularity of the euro.

OMT

- Would this actually work in practice?

Populism

- Brexit a useful case study: Makes no economic sense but “taking back control” sounds good to many.

Conclusions

The euro project has proven to be resilient.

But history never stops. Nothing lasts forever.

To keep the euro together, Europe's politicians need to

- Make the euro area less crisis-prone
- Make it easier for member states to recover from the inevitable cyclical downturns that will happen in the future.

Loads of suggestions for institutional reforms are on the table: Will politicians implement them?