

# Reflections on the Euro 25 Years on

Barry Eichengreen

# Presentation in two parts

- Why the euro area continues to experience difficulties.
- And what is to be done.

# Why 25 years?

- After all, the Euro has existed for just 18.
- One answer: rounding error.
- Better answer: because it is 25 years since:

## 7 Shocking aspects of European monetary integration

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TAMIM BAYOUMI and  
BARRY EICHENGREEN

### 1 Introduction

From all appearances the process of European monetary unification continues to gather momentum. Nearly four years have passed since the last significant realignment of exchange rates of members within the European monetary system (EMS). All significant controls on capital movements among member countries have been removed. Discussions of the establishment of a European central bank and a single currency are proceeding apace. If the current timetable is observed the transition will have been completed by the end of the decade.

At the same time there remain serious questions about the advisability of a European Monetary Union (EMU) voiced, in the most recent round of discussions, by the governments of the United Kingdom and Spain. By definition, EMU involves a sacrifice of monetary autonomy. In response to country-specific shocks, governments will no longer have the option of adopting a monetary policy which differs from that of the union as a whole. Insofar as monetary policy is useful for facilitating adjustment to disturbances, adjustment problems may grow more persistent and difficult to resolve.

These concerns are reinforced to the extent that it is believed that completion of the internal market will place new limits on the use of fiscal policy. Not only will individual governments have lost autonomy over the use of seigniorage to finance budget deficits but, insofar as the 1992 process renders factors of production increasingly mobile, constraints will be placed on their ability to impose tax rates significantly different from those of their neighbours. Limits on their ability to tax in the future will limit their ability to run budget deficits in the present; hence all important fiscal instruments may be constrained.<sup>1</sup> The sacrifice of monetary autonomy is potentially all the more serious.

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- Closing in on 2,000 citations last time I looked.
- In which we argued that proceeding with a large monetary union, including not just the Northern European core but also the “Club Med” countries, would be a mistake.

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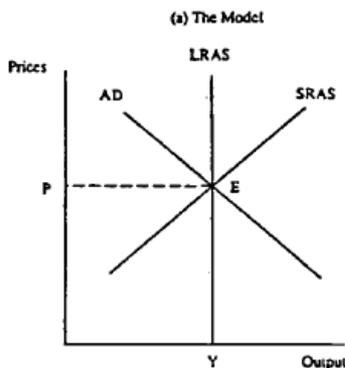
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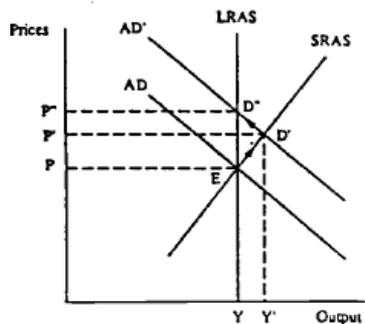
- We built on the theory of optimum currency areas.
  - As in Mundell 1961.
- This of course being the framework used by economists to study the suitability of different national economies for forming a monetary union.
- Emphasizing symmetry or asymmetry of macroeconomic “shocks” and speed of adjustment.

# Our basic framework was the textbook aggregate supply/aggregate demand model

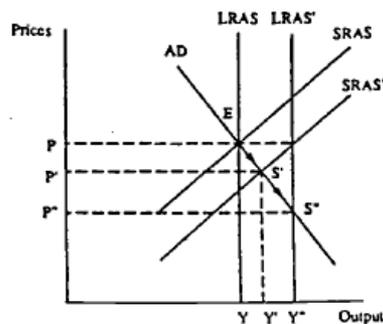
The Aggregate Demand and Supply Model



(b) A Demand Shock



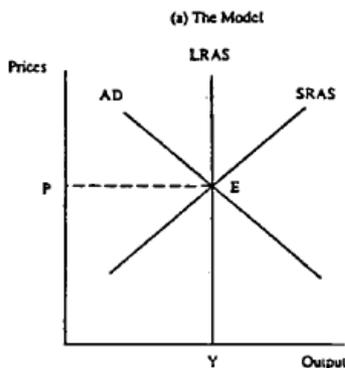
(c) A Supply Shock



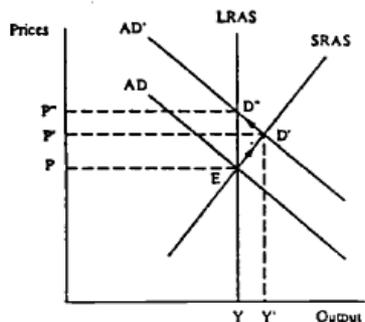
- In this model, aggregate demand shocks raise output temporarily but prices permanently.
- Aggregate supply shocks, in contrast, both raise output permanent and reduce prices permanently.

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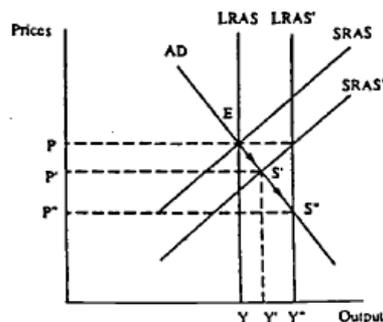
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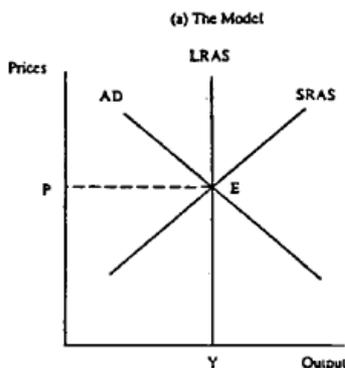
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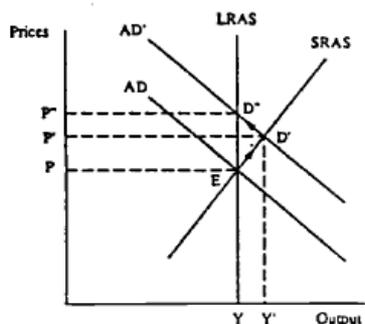
- We then estimated these two relationships using time series on both prices and output, country by country.
- We distinguished two shocks, one that was constrained to affect output only temporarily but prices permanently (“temporary” or “aggregate demand” shocks) and a second that was allowed to affect both output and prices permanently (“permanent” or “aggregate supply” shocks).

# Our basic framework was the textbook aggregate supply/aggregate demand model

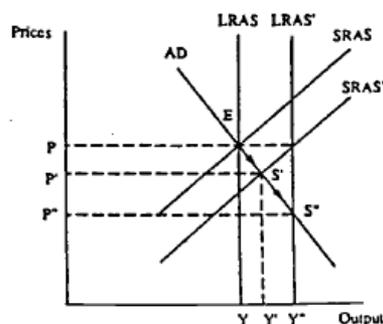
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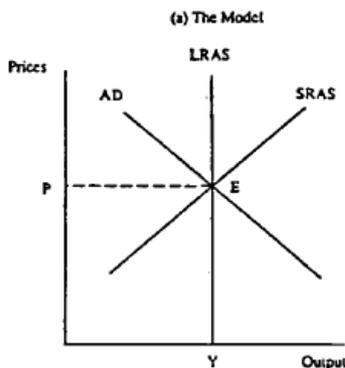
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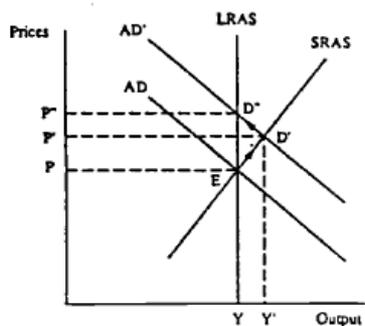
- Specifically, we estimated a bivariate vector autoregression in prices and output (more precisely, in their log differences) with 2 lags and structural restrictions imposed.
- (In the manner of earlier work by Olivier Blanchard and Danny Quah.)

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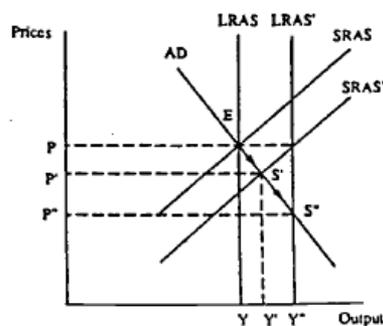
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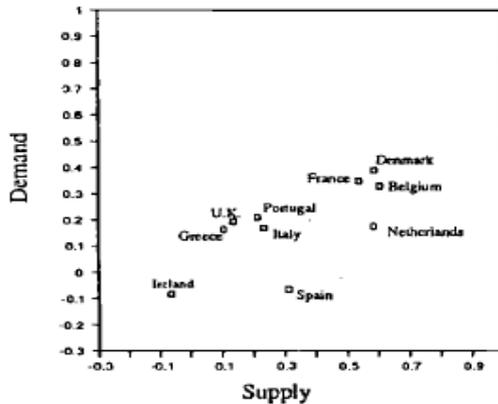


- We looked at how correlated (how “symmetric” or “asymmetric”) estimated shocks were across countries.
- Throughout, the standard of comparison was the United States, which appears to satisfy the preconditions for a workable monetary union.

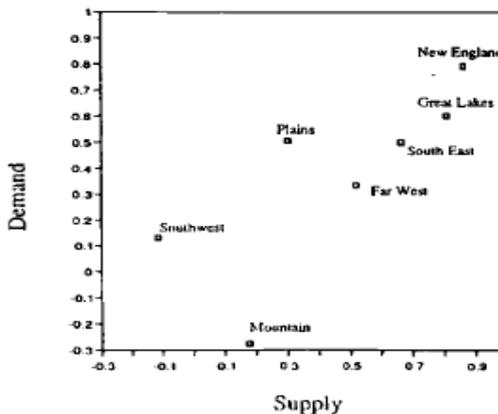
# For the period 1963-1988

Chart 4. Correlation of demand and supply shocks with anchor areas

Correlation of supply and demand disturbances with German supply and demand disturbances

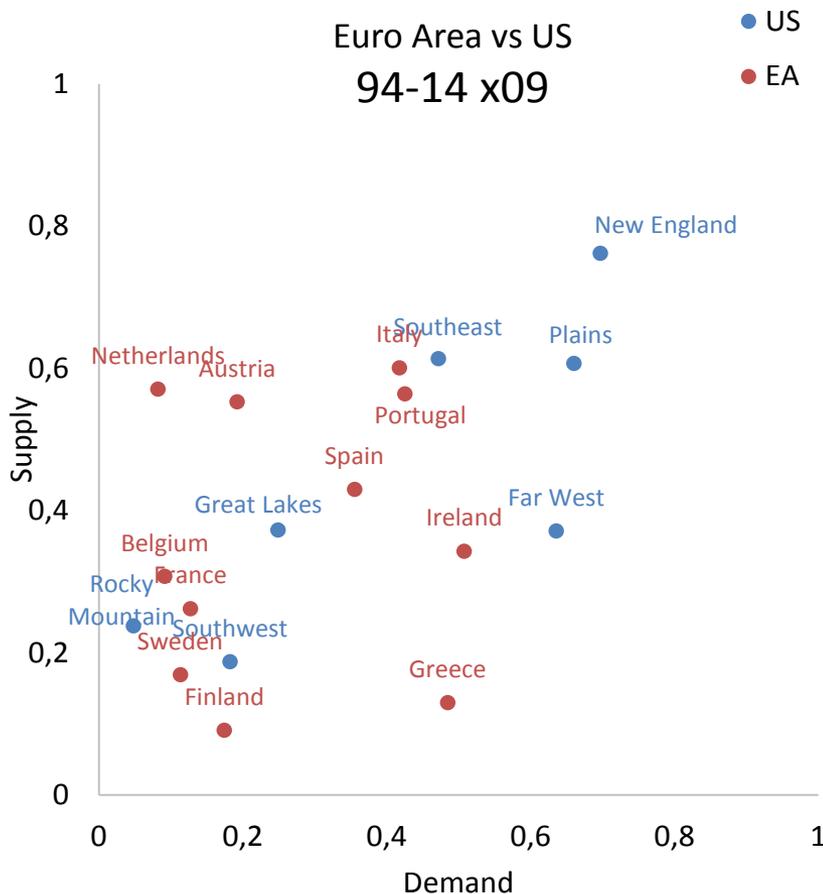


Correlation of U.S. Supply and demand disturbances with supply and demand disturbances of mid-east region



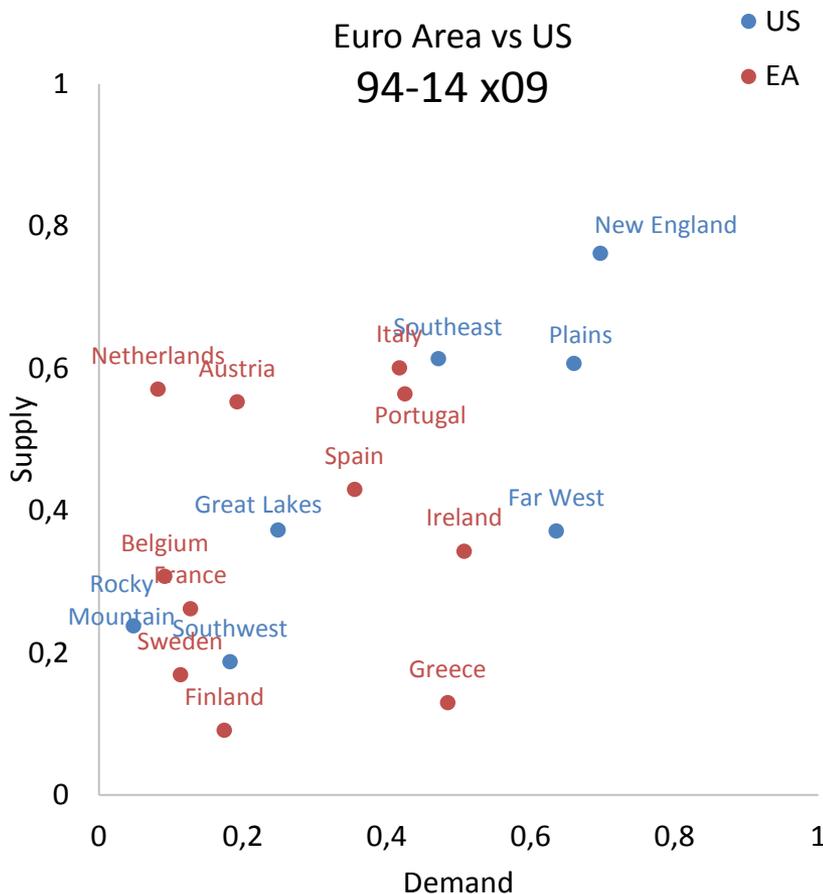
- Correlation of shocks with those in the anchor region (Germany and the Mid-Atlantic states respectively) was lower in Europe than the US.
- Moreover, there was a distinction: members of European “core” resembled the US, while “Club Med” countries did not.
- Notice who the problem countries were here: Portugal, Ireland, Italy, Greece and Spain – together with the UK.

# Here's the update (1994-2014)



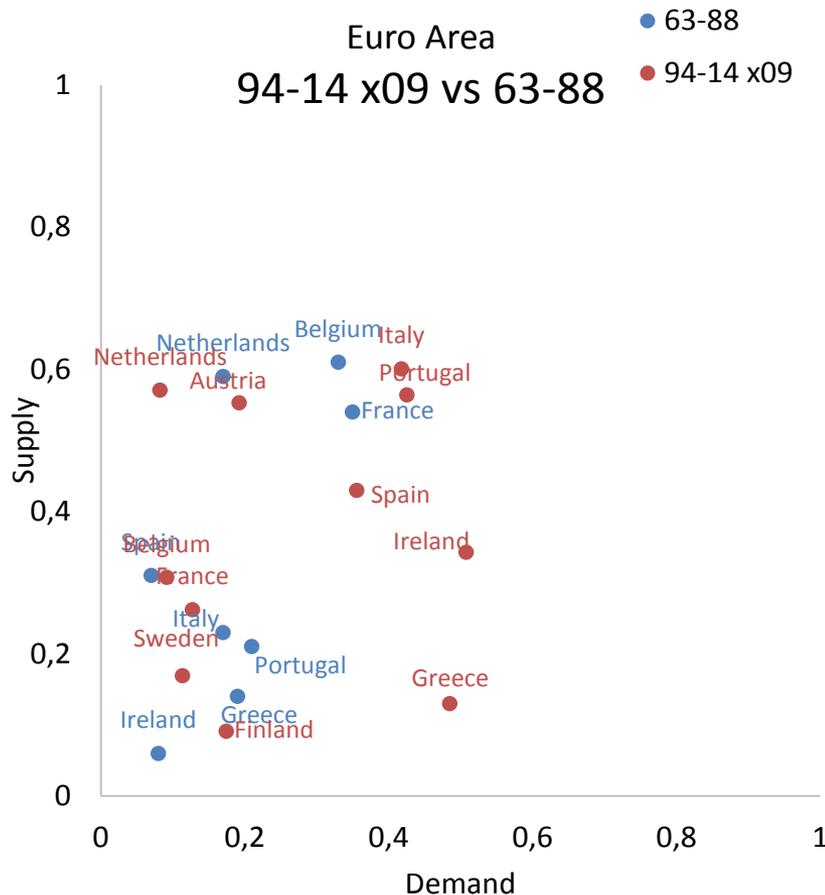
- Europe still looks like less of an optimum currency area than the United States, judged by the symmetry of shocks.
- To be a smoothly-functioning monetary union, you want to be toward the upper right.
- But red dots for Europe tend to be lower and to the left.

# Here's the update (1994-2014)



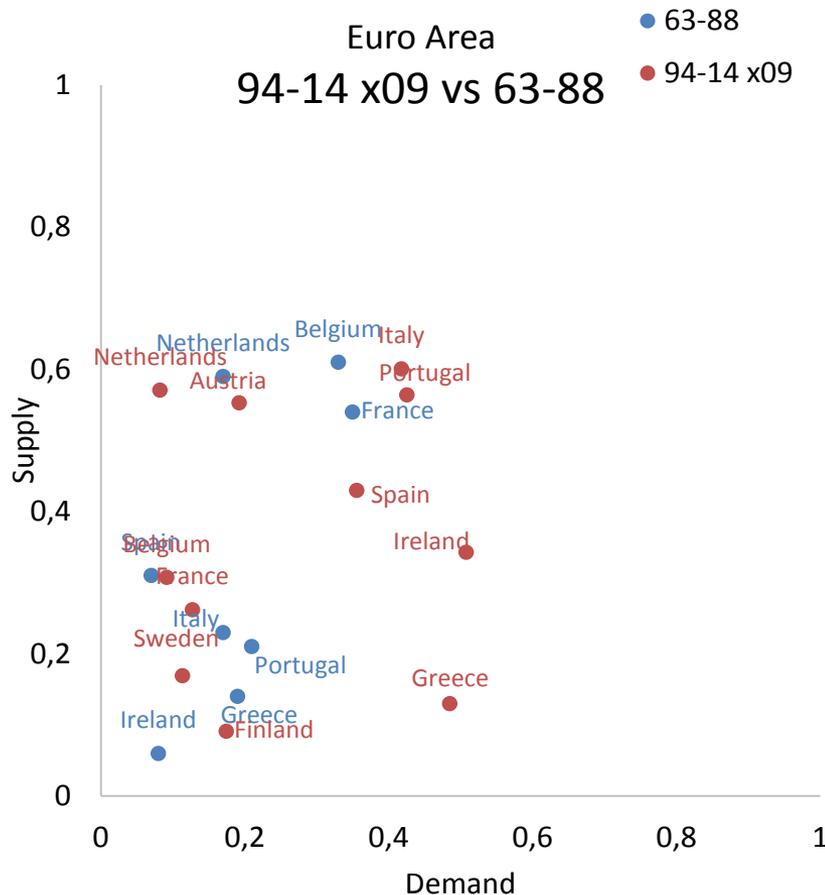
- The US figure looks almost identical to before.
- The main change is that the Great Lakes have moved down and to the left (perhaps reflecting the ongoing decline of manufacturing there).

# Europe looks a bit more like an optimum currency area today than in 1963-88



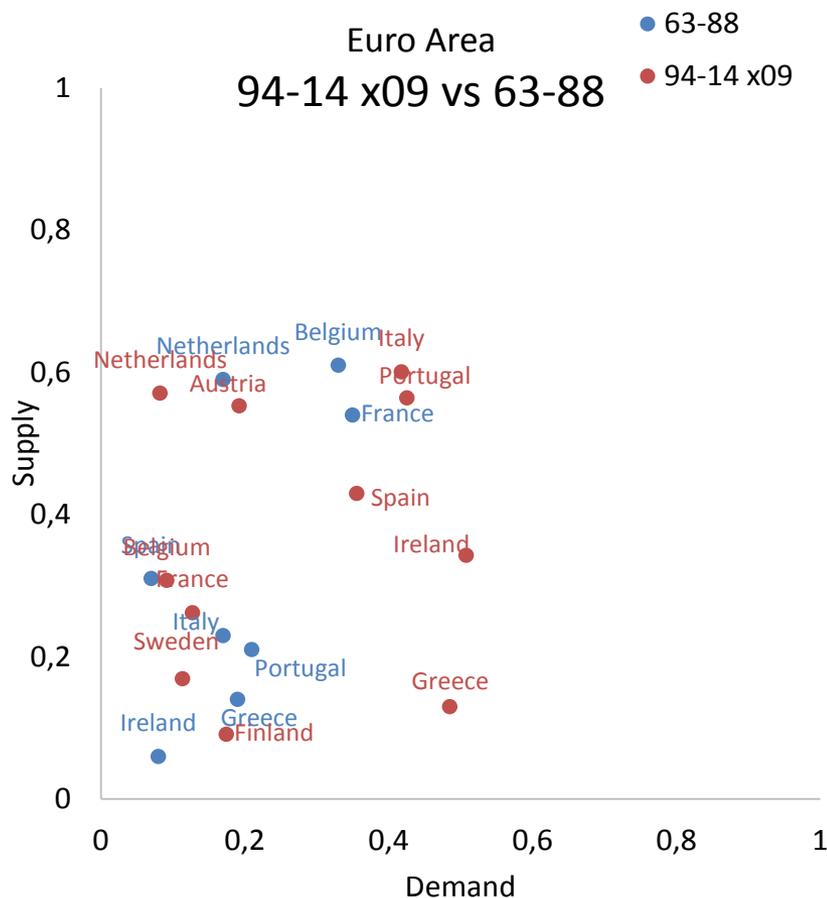
- While the symmetry of aggregate supply shocks remains the same as in the earlier period, demand shocks have grown more symmetric.
  - Red dots are further to the right than blue dots.
- This is not unexpected.
  - Monetary policy shocks are now more symmetric.

# Europe looks a bit more like an optimum currency area today



- But what is unexpected is that shocks (demand shocks especially, but supply shocks as well) have grown more symmetric with those in Germany not in Northern Europe but in the crisis countries.
- This is the key finding of our update.

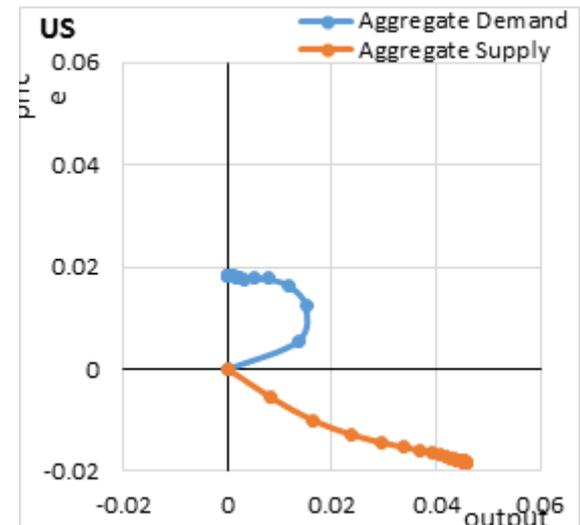
# Europe looks a bit more like an optimum currency area today



- We suspect that this reflects capital flows between “Northern” and “Southern” Europe on a scale that did not exist before the euro.
- Large capital flows from Germany to the South led these economies to boom together between 2001 and 2008 in particular.
- The fact that these correlations turn out to be lower when we control in the VARs for a variety of financial variables is consistent with this interpretation.
- And there is a further twist...

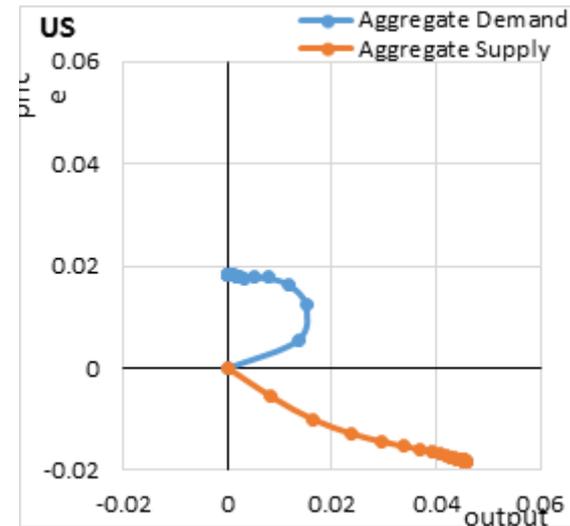
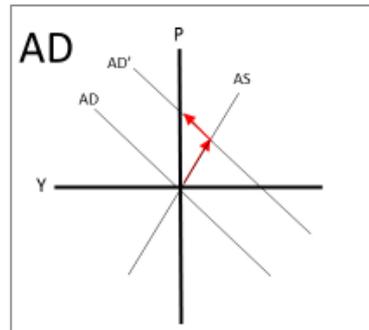
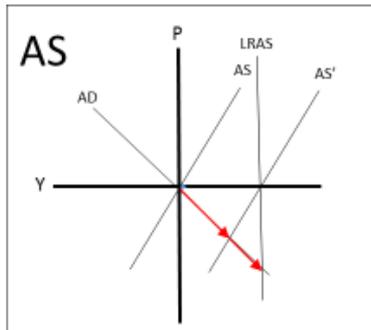
# The impulse-responses for the US conform to the textbook model

- When we update from 1972-88 to 1994-2014, the U.S. impulse-responses are “well behaved” – they look the same as before.
- Demand shocks (in blue) raise output temporarily, prices permanently.
- Supply shocks (in red) raise output while reducing prices.



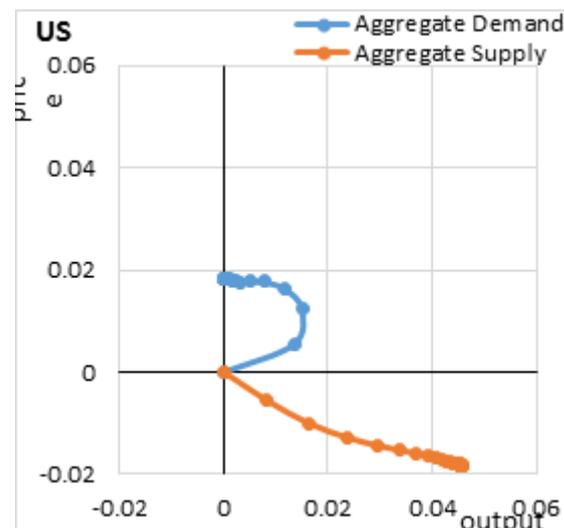
# They look like this, in other words

US Adjustment: AD/AS



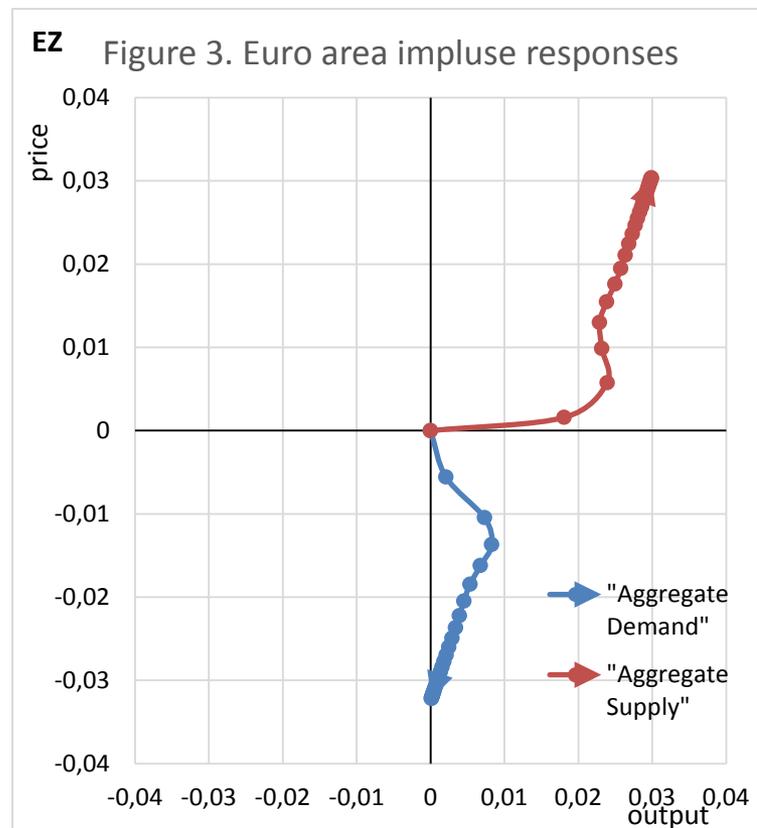
# In Europe, however, the impulse responses now look peculiar

- They were “well behaved” before the Euro (as at right).
- But now:
  - Positive supply shocks raise output but also raise prices.
    - Where the textbook says prices should go down.
  - Positive demand shocks appear to reduce prices
    - Where textbook economics say they should raise them.



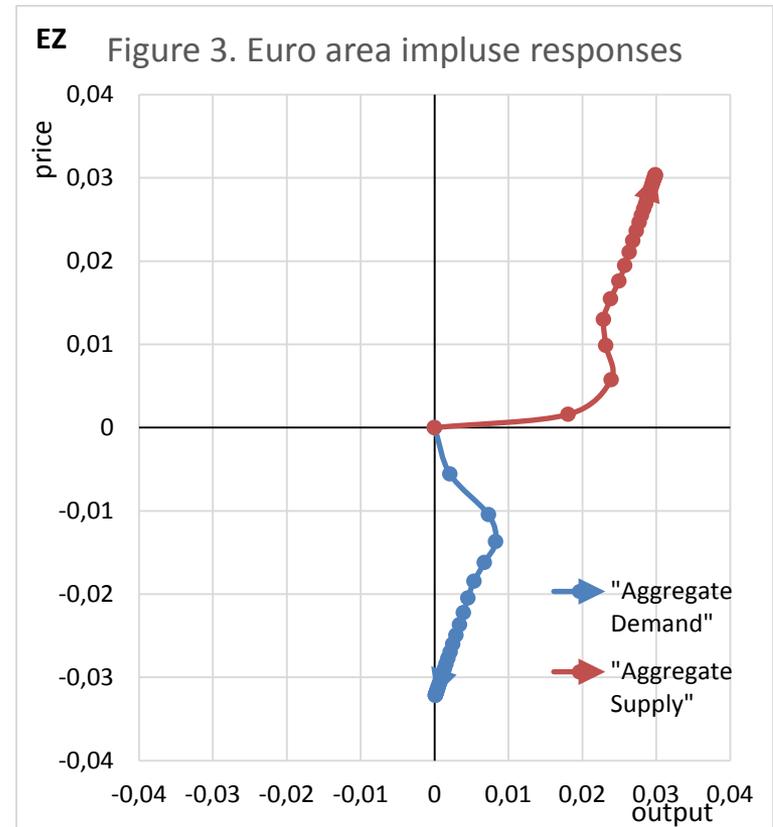
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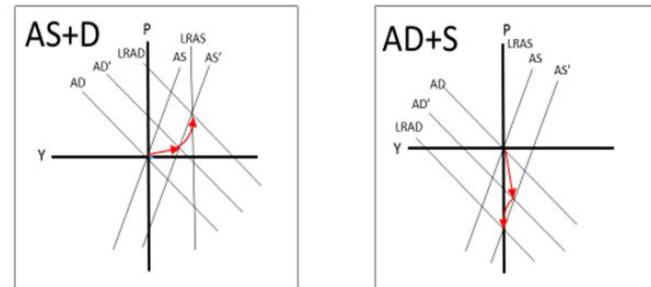
# So how might we understand this?

- What are the underlying economics, in other words?



- Our hypothesis is that the positive AS shock sets off a positive AD shock.
- And the positive (negative) AD shock sets off a negative (positive) short-run AS shock.

Figure 4: Euro Area Adjustment:  
Financial Hysteresis



# Explaining how the impulse responses can look like this

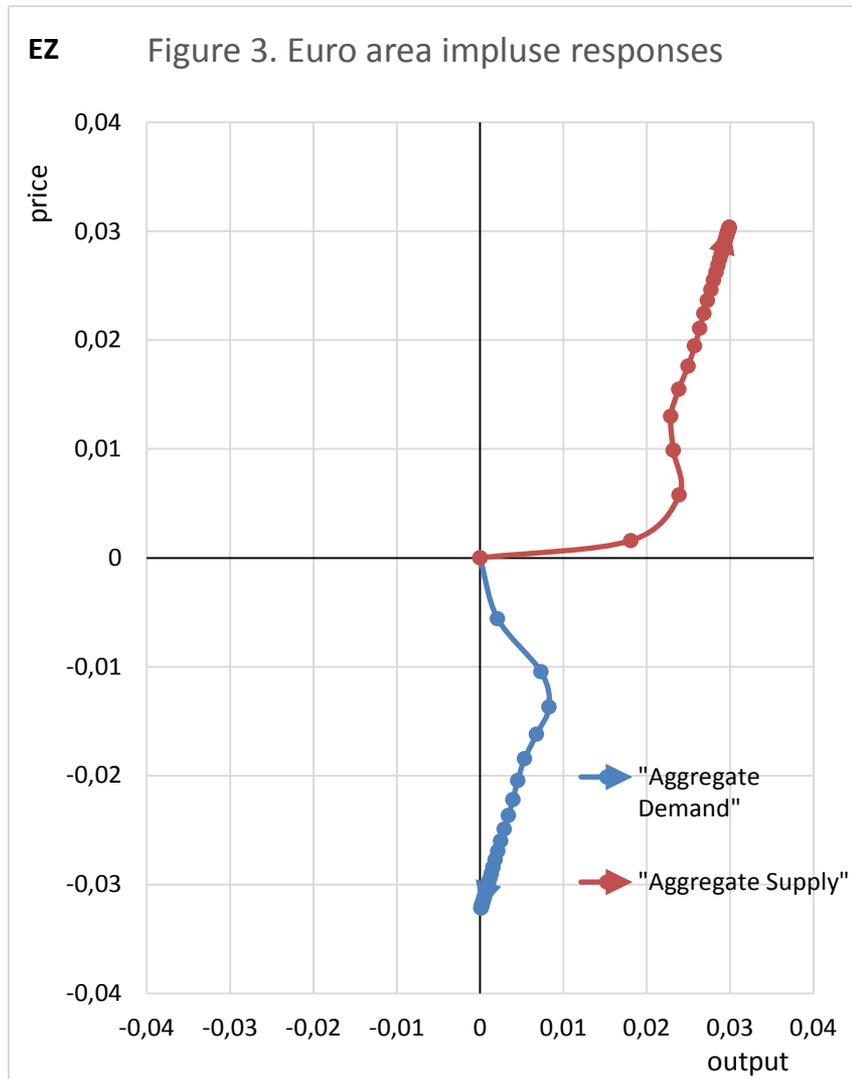
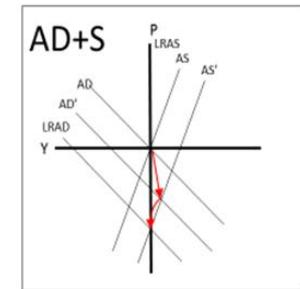
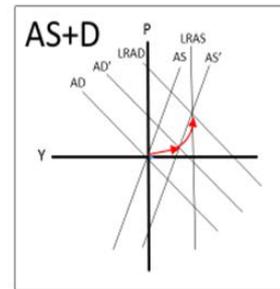


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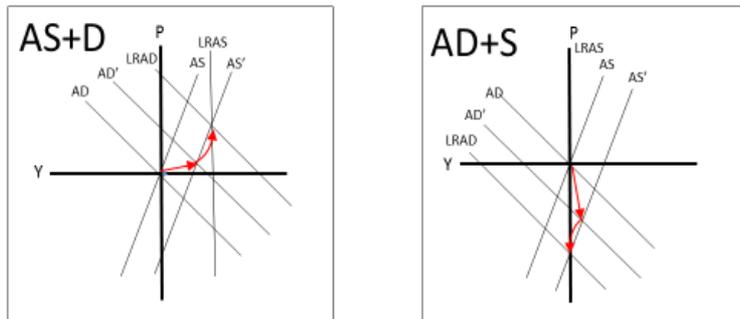


# Our hypothesis: hysteresis and the financial cycle

- The financial cycle means that positive supply shocks set off a financial response also affecting demand.
- And that positive demand shock is permanent, absent another shock (hence the hysteresis).

# Hysteresis and the financial cycle

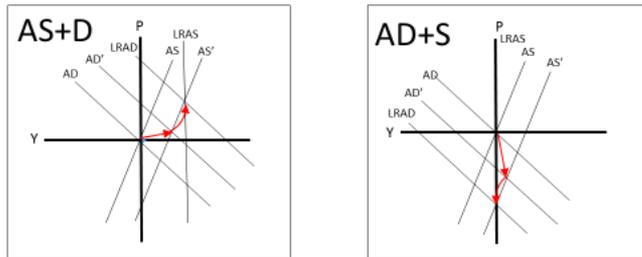
Figure 4: Euro Area Adjustment:  
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- Consider the left-hand panel.
- A positive supply shock first raises output.
- Because (plausibly) a more stable policy environment due to the euro increases supply.
- This boosts productivity and profitability.
- This in turn raises asset prices and sets off a lending boom.
- The lending boom increases aggregate demand (in the case depicted, even more than supply).
- And the higher prices result.
- This is the “pre-2008 case,” when the peripheral countries experienced a positive supply shock, a lending boom, and higher output together with higher prices (a loss of competitiveness).

# Hysteresis and the financial cycle

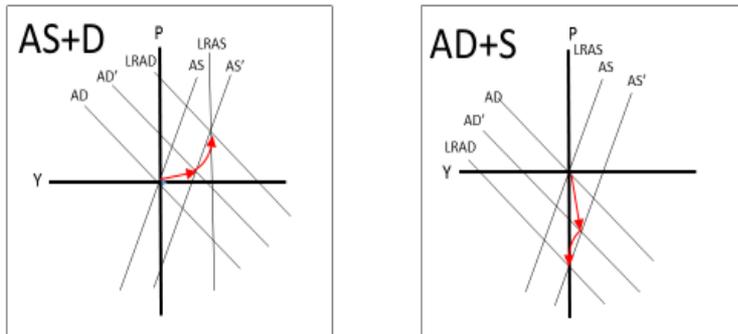
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Financial Hysteresis



- Now run the experiment in reverse (“post 2008”).
- Think of a negative supply shock due to impairment of the financial system.
- Lower prices mean an asset-price slump and therefore less lending.
- Demand falls along with supply (demand curve shifts to the left).
- The result is recession and deflation. Hysteresis implies that there is a permanent decline in output.

# For completeness, consider the right-hand panel

Figure 4: Euro Area Adjustment:  
Financial Hysteresis



- Negative demand shock reduces output, but also induces an increase in aggregate supply.
- Intuitively, prices fall with the negative demand shock, which makes producers more competitive on international markets (higher export margins), inducing them to increase supply.
- While output remains roughly unchanged, prices fall.
- So again, the result of post-2008 events is temporary stabilization of output (2008-9) but deflation.

# Conclusion to Part 1

- It is no surprise that the Euro Area continues to experience difficulties.
- It remains further than the benchmark represented by the United States from satisfying the preconditions for an Optimum Currency Area.
  - Shocks are still asymmetric.
  - Adjustment remains difficult (no fiscal federalism, lower levels of labor mobility).

# Conclusion to Part 1

- Moreover, the evidence suggests that while the € had positive efficiency effects, that positive supply shock unleashed large capital flows between Northern and Southern Europe, inflating asset prices in the South.
- This lending boom boosted demand in Southern Europe, creating the mirage of prosperity but also leading to a permanent loss of competitiveness.
- Suggesting the need to do something about this capital-flow problem and its effects.

# Introduction to Part 2

- So what can be done?

# It would be nice to think that Europe could boldly complete its monetary union

- Meaning that it could:
  1. Complement its single monetary policy with a single fiscal policy (create a federal fiscal system).
  2. Mutualize its debt.
  3. Establish a true single labor market.
  4. Create a political union to provide accountability for those making these Eurozone-wide fiscal, monetary and labor policies.



- But alas we know that this is not realistic.
  - There is no political appetite for such ambitious steps.
  - Certainly not in the short run.
- Given this, can we imagine more limited steps that would be effective?
  - In other words, can monetary union work without political union, and if not should we give up the ghost?



I will argue that four steps, all of which are possible without political union, suffice for survival of the euro

1. Establishing a normal central bank.
2. Completing the banking union.
3. Renationalizing fiscal policy.
4. Removing debt overhangs.

In what follows I will elaborate this argument.

The starting point for doing so is by asking: how should we think about organizing the provision of monetary stability, financial stability and fiscal stability (which are what a workable monetary union requires)?

# In thinking about provision, a useful framework is “club theory”

- When tastes are relatively homogenous, spillovers are significant and there are increasing returns to collective action, decision making should be centralized.
- But where spillovers are more limited and tastes are heterogeneous, responsibility should be decentralized.
  - Viz. James Buchanan 1965.
  - Viz. The Principle of Subsidiarity.
  - Let me now return to my four minimal conditions and how they fit into this framework.

# A normal central bank

- I define a normal central bank as one able to pursue flexible inflation targeting and to backstop banking systems and markets in government bonds, thereby protecting the euro area from potentially self-fulfilling crises.
- Theory and evidence argue strongly for centralized provision.
  - Spillovers of monetary policy and of doubts about the integrity of the euro area are powerful.
  - Preferences over inflation are not that different (er....)
- This function was not provided initially.
  - The ECB's two-pillar strategy focused on inflation and monetary aggregates but not lender- and liquidity-provider-of-last resort functions.
  - Even inflation targeting was asymmetric.
  - In addition, the ECB concentrated on headline rather than core inflation, causing it to raise interest rates in 2008 and 2011.

# Things changed under Draghi

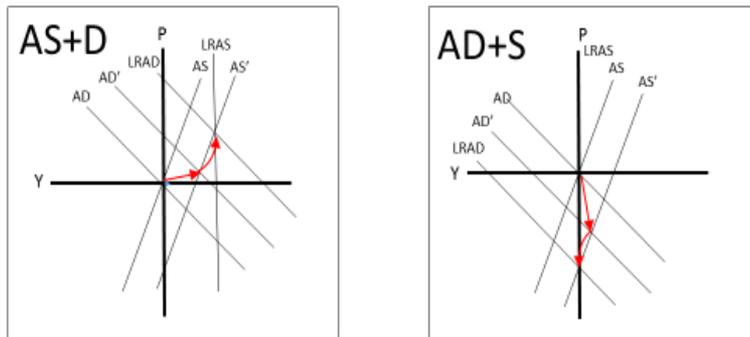
- And with “do whatever it takes” in 2012.
  - Outright Monetary Transactions to achieve it.
- Symmetric inflation target.
  - QE with capital key to achieve it.
- Given this, what more is now needed to establish a normal central bank?
  - Greater transparency commensurate with greater responsibility and increase in the range of action.
  - A smaller Governing Council able to move more quickly.

# A full-fledged banking union

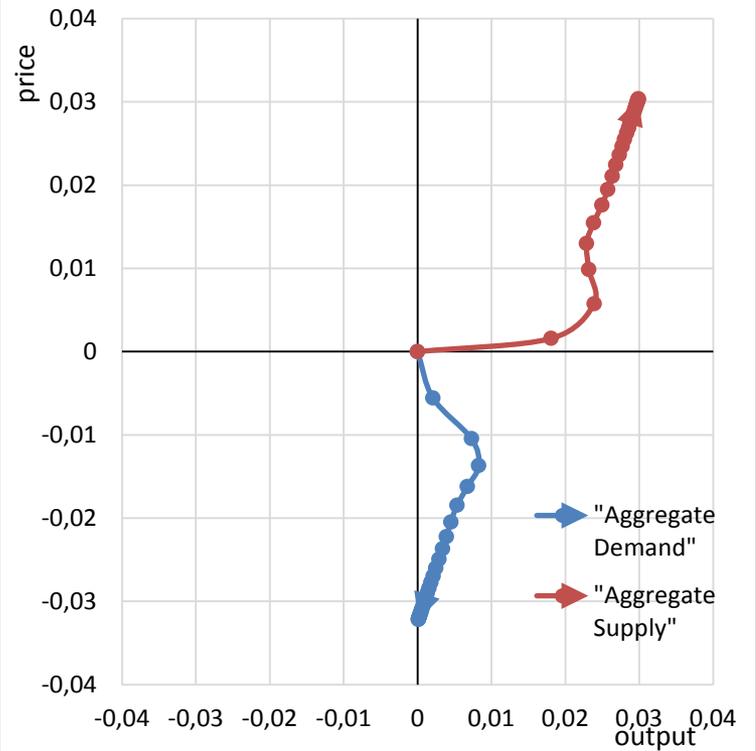
- The crisis has underscored how banking-system stability is a euro-area-wide public good subject to strongly increasing returns (spillovers are powerful, in other words).
- One need only recall how lax regulation of French and German banks allowing these institutions to lend hand over fist to Southern European countries set the stage for the crisis, or how the subsequent problems of some banks then threatened to destabilize others via the interbank market.
- Experience has shown that this is an area where strongly increasing returns from centralized provision dominate any costs of uniformity.
  - As the point is sometimes put, monetary union without banking union will not work.

# A point that is underscored, I would argue, by these findings

Figure 4: Euro Area Adjustment:  
Financial Hysteresis



EZ Figure 3. Euro area impulse responses



# Europe now has half a banking union

- Single supervisor.
  - But for biggest 130 banks only.
  - Adequacy of “federalized” supervision for other banks is unclear.
- Bank Recovery and Resolution Directive.
  - But is it feasible? Has the Italian problem changed views?
- And as yet no harmonized deposit insurance with a common financial backstop.

# Renationalization of fiscal policy

- EU approach has been to centralize fiscal policy on the assumption that spillovers are large.
- But all the evidence suggests that the spillovers of budget deficits are small.
  - Spending and interest rate effects go in opposite directions.
  - (There is a distinction between deficits and debts, to which I will return.)
  - Even the ECB acknowledges this: see Attinasi, Lalik and Vetlov, “Fiscal Spillovers in the Euro Area,” ECB WP 2040 (March).
- And countries clearly have heterogeneous tastes regarding fiscal policy.
  - All this suggests returning control to the national level.

# But to work, renationalization requires two things

- A credible no bailout rule.
  - This requires disconnecting banks and government bond markets.
    - Recall how it has repeatedly been fear of banking crises/failures that have led to bailouts.
- Removing inherited debt overhangs.
  - Otherwise, there will be little scope for national action/discretion.
  - Otherwise, spillovers due to default and solvency concerns will be amplified.
    - We know how to do debt restructuring; Europe has just shown a reluctance to deploy that knowledge.

# Conclusion

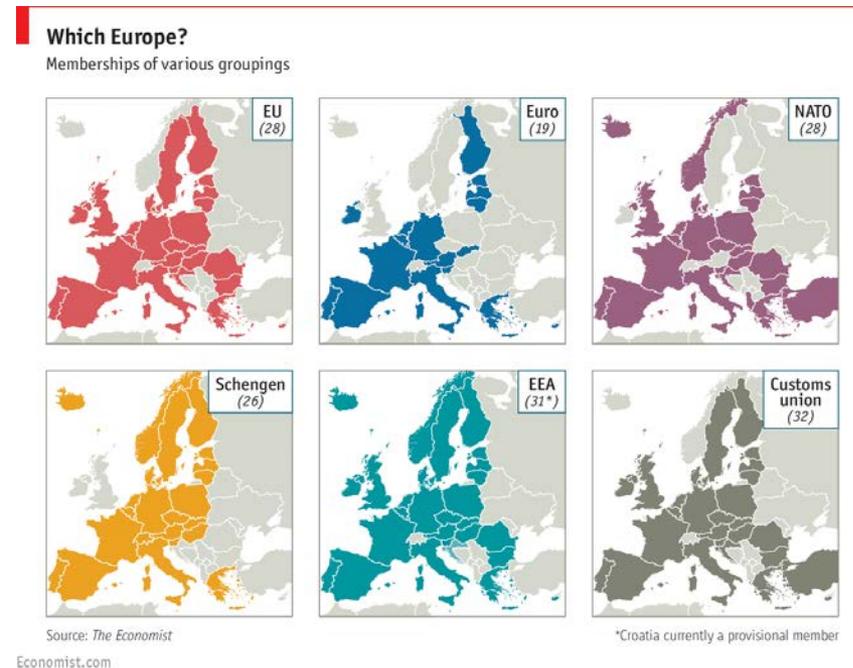
- Does the Euro Area need more integration or less integration?

# Conclusion

- Does the Euro Area need more integration or less integration?
- Answer: the Euro Area needs both. And club theory suggests along what dimensions.

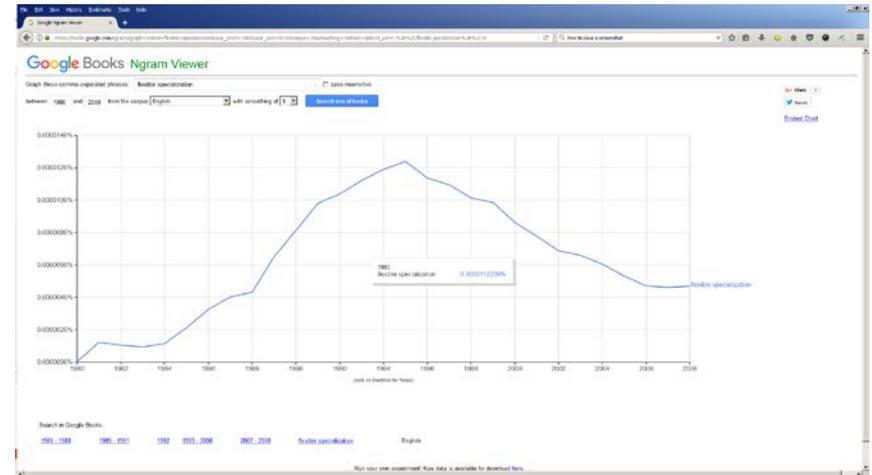
# It also suggests that “two-speed Europe” is not on

- This was proposed by Karl Lamers and Wolfgang Schauble way back in 1994, and it is back, courtesy of Macron and Schultz.
- But this is not the right model.
- Denmark is in the Schengen Agreement but outside the euro; Ireland is in the euro but out of Schengen. Etc.



# Instead, we are talking about flexible specialization

- But not even the “5 Presidents Report” really discusses this possible.
- Even the term has fallen out of fashion.
- The question is why?



# Answer: governance problems

- A strengthened EU and euro area require greater accountability to enhance the legitimacy of European integration and beat back the populist anti-EU reaction.
- But the European Parliament is not obviously an adequate vehicle for this.
  - It is remote to European voters.
  - It contains both countries in and out of the various clubs.
- Thomas Piketty and coauthors suggest a Eurozone Assembly to be established alongside the EP, to be made up of a selection of MEPs and a selection of national parliamentarians.

# Problems

- Two is not enough, given that the problem is not simply euro ins and outs.
- It assumes that national parliamentarians will have the bandwidth and that national parliaments will rearrange their schedules.
- The EU actually tried this before 1979, when the EP was made up of national parliamentarians nominated by their countries. Shortcomings of that system was what led Europe to adopt today's status quo.

# Solution: Work within the framework of the European Parliament

- Different subgroups of members would vote on different issues, depending on country membership.
- If EP was endowed with additional power (to initiate legislation and reject a broader range of directives proposed by the Commission), voters would have less reason for apathy and more reason to pay attention.

# Solution: Direct election of the President of the Commission

- Current system (where Council selects a candidate and the Parliament confirms) puts two layers of separation between the EU's proto-executive and the people.
- Direct election becomes even more important as the president acquires executive powers (over inter alia foreign and security policy).
  - Objections: campaign in all 27 member states; linguistic limitations.
  - But we have these problems in the US too.

- I am happy to take your questions.