

ECONOMIC POLICIES IN THE EMU I

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Outline

1. The EMU and the theory of Optimal Currency Areas
2. The EMU setting and its performance up to the crisis
3. EMU crisis events and policy response
4. EMU crisis narratives

EMU AND OCA THEORIES

Events towards the EMU

- European integration: Customs union, free movement of labour and capital
- 1979 European Monetary System (EMS) as a substitute for Bretton Woods
 - Exchange rate Mechanism (ERM): currencies allowed to move in 2.25% bands
 - Long-term vision of monetary integration
- 1986 Single European Act to complete the single market, includes free capital movement
- 1988 Delors Committee on EMU, dominated by Bundesbank ordoliberal thinking
- 1992 EMS crises
- 1992 Maastricht treaty
- 1997 Stability and Growth Pact (SGP)
- 1999 EMU

Why form a currency area / monetary union?

→ For 5min: Please discuss the pros and cons

Pros:

- Reduce costs of XR fluctuations → foster trade and growth
- Benefit from lower interest rates
- Better protection against common shocks (more firepower, coordination)
- Stop beggar-thy-neighbor currency devaluation wars
- In Europe: enforce political union / peace („Lokomotivtheorie“ vs. „Krönungstheorie“)

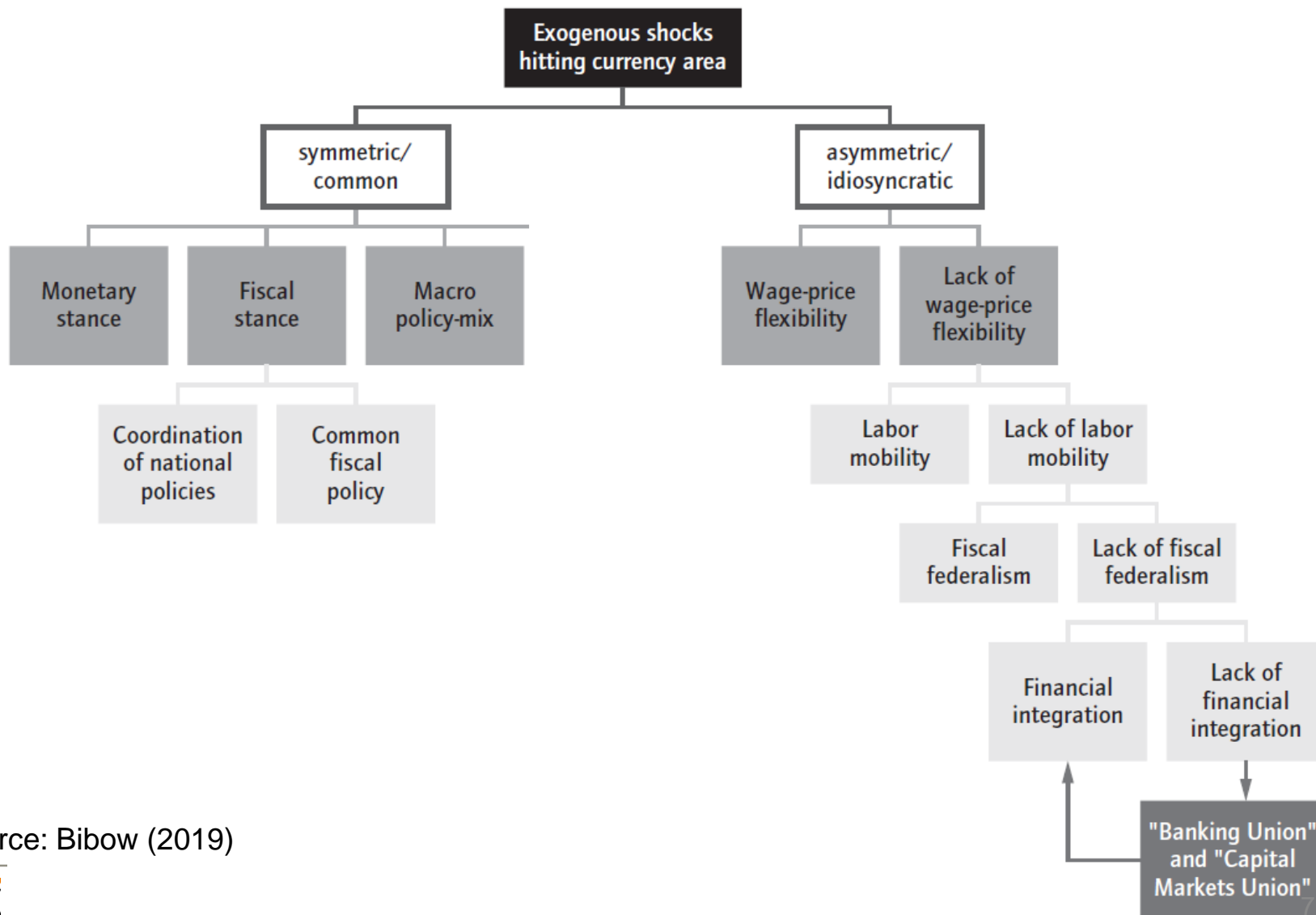
Cons:

- Vulnerability to asymmetric shocks
- In Europe: do it, but do it only half-way! (insufficient institutions)

OCA Theories

- Friedman (1953): flexible **XR are key stabilizers** when wages/prices inflexible
- Mundell (1961): with fixed FR wage/price flexibility would be key, but not the case → **labour mobility** as main remedy → **OCA** should be **small**
- McKinnon (1965): in **small open** economies, due to real wage rigidities, XR shocks are in-/de-flatory anyways → **OCA** can be **large**
- Kenen (1969):
 - importance of **diversification** to cope with asymmetric shocks
 - Close **control over money wage** rates (and thus inflation)
 - **Fiscal union** as remedy for missing labor mobility
 - **Developing** countries should stay with **flexible XR**
- Mundell (1973)
 - Under strong capital mobility: XR flexibility destabilizing → **fixed XR is stabilizing** and fosters capital market integration → **OCA** should be **large**
- Tavlas (1993): **criteria approach** (similar inflation rates, factor mob, diversification, price wage flex, fiscal integration) → kind of score board, but advantage of hard currency of the MU outweighs deficiencies. But countries which would benefit most from hard currency, usually do not score well in the criteria

Factors of an OCA



Source: Bibow (2019)

Optimal Currency Area (OCA)

From the list of factors of an OCA, the construction of EMU has largely focussed on

- Labor and capital mobility
- Price and wage flexibility
- Diversification (?)

Largely ignored

- Convergence in inflation rates
- Fiscal federalism
- Political union
- Irrevocability of the decision to enter a currency *union* as compared to currency *cooperation*

Research on OCA Europe vs. US

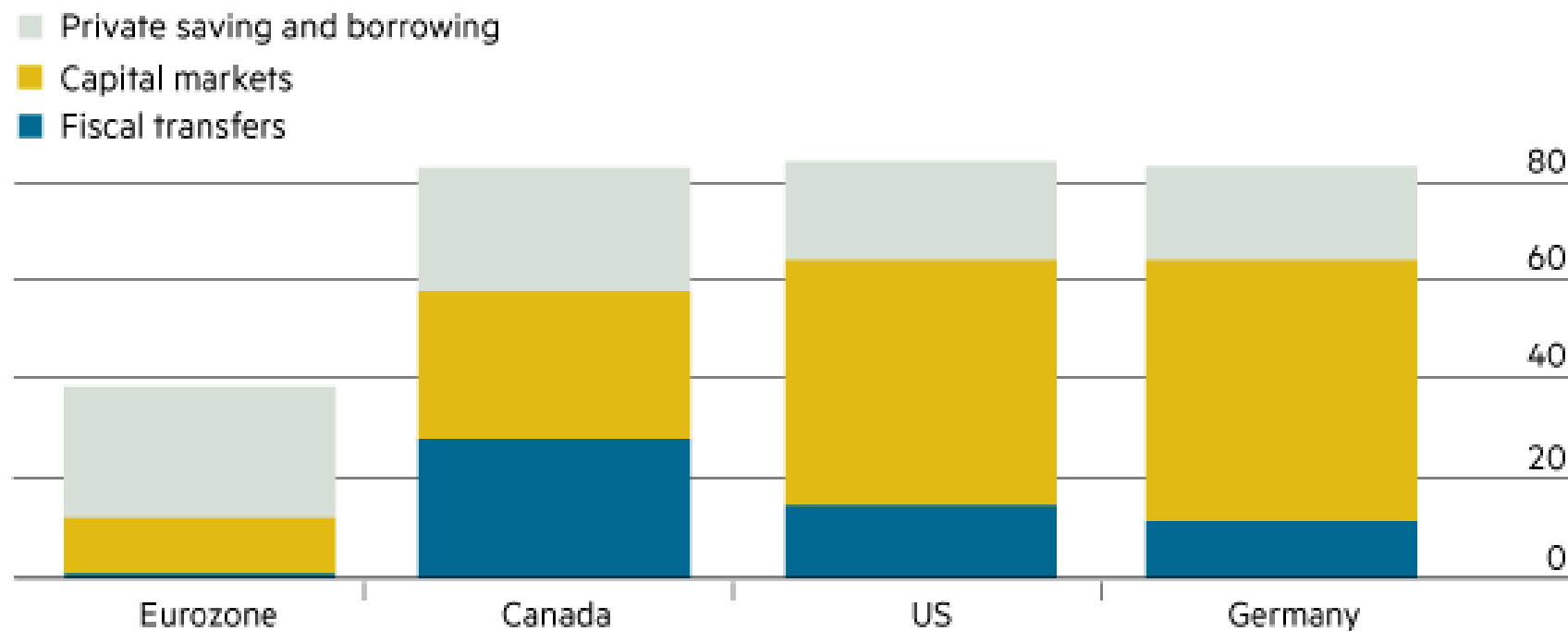
- Bayoumi and Eichengreen (1993): **core** countries are hit by **common** shocks, **periphery** is often **asymmetric** to that
- Blanchard and Katz (1992): **labor mobility much smaller** in Europe than in US
- Bini Smaghi and Vori (1992): European economies **more diversified** / more similar than US states
- **Endogeneity of fitness**
 - Frankel and Rose (1998): once EMU established, countries would become fitter
 - Krugman (1993): EMU will lead to **more specialisation** → less fit

Asymmetric shocks and risk sharing facilities

- Fatás (1998): fiscal **interregional stabilisation** in the US fiscal union only **10-15%**.
 - European national FPs even better equipped for asymmetric shocks (automatic stabilizers) and can coordinate against common shocks
 - But warns of **dysfunctional countercyclical** tools due to SGP. → federal budget necessary
- Asdrubali et al. (1996): **Capital/credit market integration is key** for risk sharing in the US:
 - capital markets 39%,
 - credit markets 23%,
 - federal fiscal system 13% of risk sharing

Risk sharing in monetary unions

Degree (in %) to which regional consumption is insulated from regional GDP fluctuations, by mechanisms for smoothing



FT graphic Source: Céline Allard et al

Sandbu (2015)

Assymmetric shocks and risk sharing facilities

- Dullien (2019): critique on Asdrubali et al. measurement
 - **Direct federal** spending in states ignored for fiscal stabilisation
 - **Vertical transfers** ignored
 - Intertemporal **smoothing of profits and consumption** fully counted as cross-border capital and credit market stabilisation
- Farhi & Werning (2017) Interconnectedness / **complementarity** of the above channels? → central fiscal capacity allows other channels to work
- **Inequality** issues: who can rely on capital income spatial portfolio diversification?

EMU SETTING AND ITS PERFORMANCE UP TO THE CRISIS

The Asymmetric Maastricht Convergence Criteria

- Inflation: No more than **1.5 pp** higher than the average of the three best performing (lowest inflation) member states of the EU
- Nominal Interest rate: must not be more than **2 pp** above average of best performers
- FX rate: join ERM and **no devaluation** within application period
- Public budget deficit: 3 % of GDP (with exceptions)
- Public debt: 60% of GDP, at least approaching

→ Asymmetric criteria

→ No mention of

- Real convergence: income/head, unemployment rates
- Diversification
- Current account position, private debt

New Keynesian, New Political Economy and Monetarist theoretical underpinnings of EMU

- **Inherently stable markets with frictions** that should be reduced
- Dominance of **inflation target** over unemployment target
 - Only short-run trade-off, low **stable inflation** also **conductive to healthy GDP** growth in the medium to long run. „*Divine Coincidence*“ (Blanchard and Gali 2007)
 - Inflation is primarily a **monetary phenomenon** in the medium to long run.
 - NAIRU and potential output are **supply-determined**
- Active Monetary Policy (**MP**) **dominates** active Fiscal Policy (**FP**) in macroeconomic stabilisation.
 - MP is quicker and rules-based (independence) → (asymmetric) inflation targeting via interest rate tool (and more recently forward guidance) → long term rates follow suit to CB rate → **well-behaved yield curve**
 - Due to Ricardian equivalence (distortionary taxation) and confidence effects, active FP has **low multiplier effects**
- Passive FP (automatic stabilisers) is **sufficient** and rules based
- “**Solid**“ **public finances** instead of „functional“
- Fiscal rules enforce balanced budget and **avoid moral hazard**

Concrete institutional setting on the outset

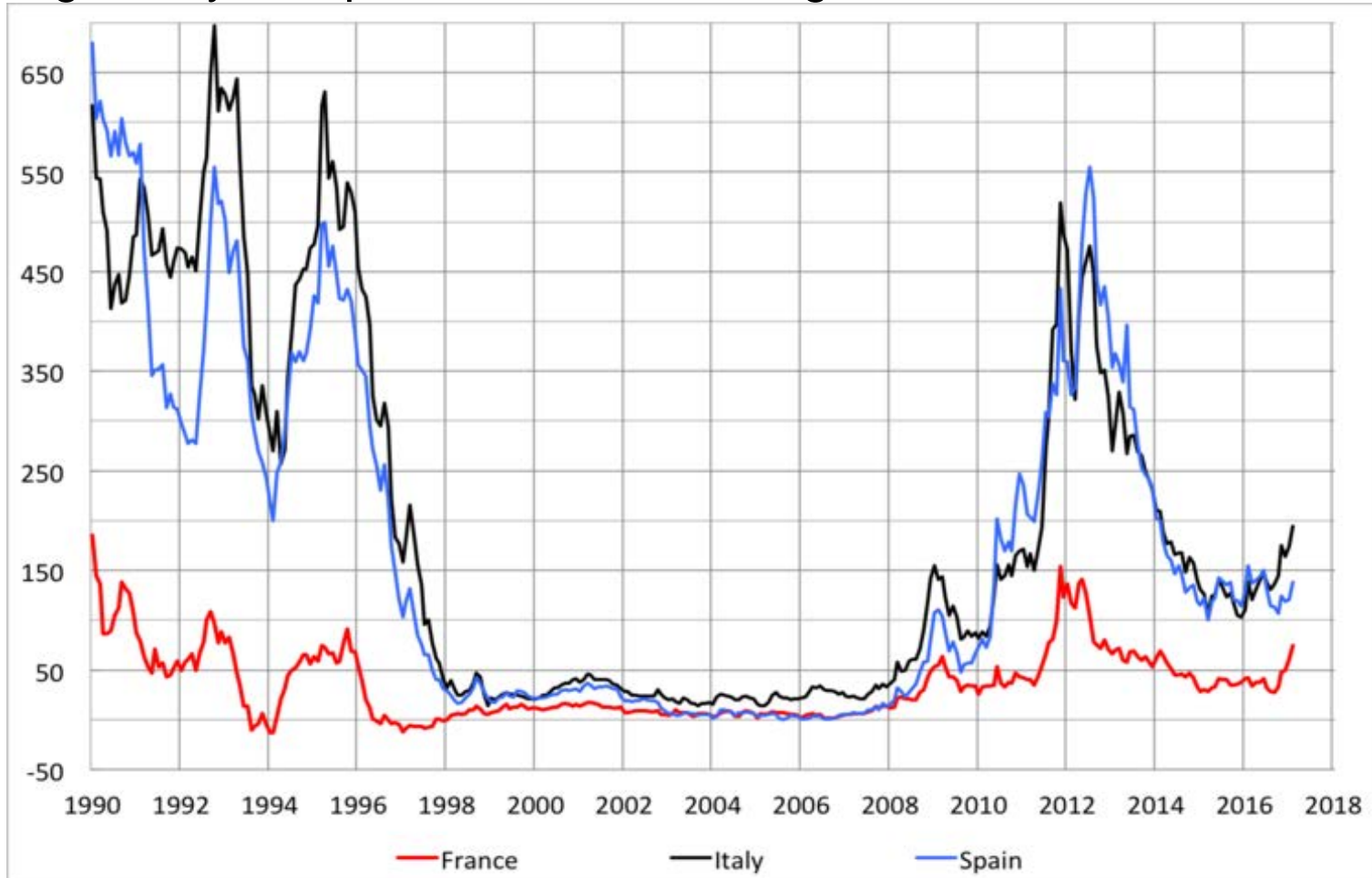
- Independent community level (one size fits all) MP,
 - pursuing (asymmetric) inflation target, $<2\%$
 - 2nd pillar of monetary analysis, M3 growth $<4.5\%$ (Monetarist Bundesbank heritage)
 - “pursuit of additional objectives ... would ultimately result in higher inflation and higher unemployment.” (ECB 2008)
 - No control over country-heterogeneity in inflation and real interest rates
- Rules based (asymmetric) FP enshrined in SGP
 - Initially (1997): perpetuation and tightening of Maastricht fiscal goals (3% def rule as exception + “achieve a budgetary position of close to balance or in surplus over a complete business cycle.”)
 - Reform (2005) to include country-specific Medium-Term Objectives (MTO)
 - Structural balance max. 1% of GDP or balanced for MS with debt sustainability issues. Adjustment path of annually -0.5pp
 - Excessive Deficit Procedure
 - „Structural reform“ exception

Concrete institutional setting on the outset

- Structural policies aiming at **more flexible and competitive** labor, product and financial markets.
 - Financial integration should be market-led. Public policy should not intervene, would create distortions
 - “rigidities in the wage and price-setting mechanisms or ongoing excessive wage developments may delay the **necessary adjustments** of relative prices to economic shocks and thereby give rise to inflation persistence.” (ECB 2008)
- “peer pressure and support”, “some degree of **policy competition** aimed at improving policy efficiency” (ECB 2008)

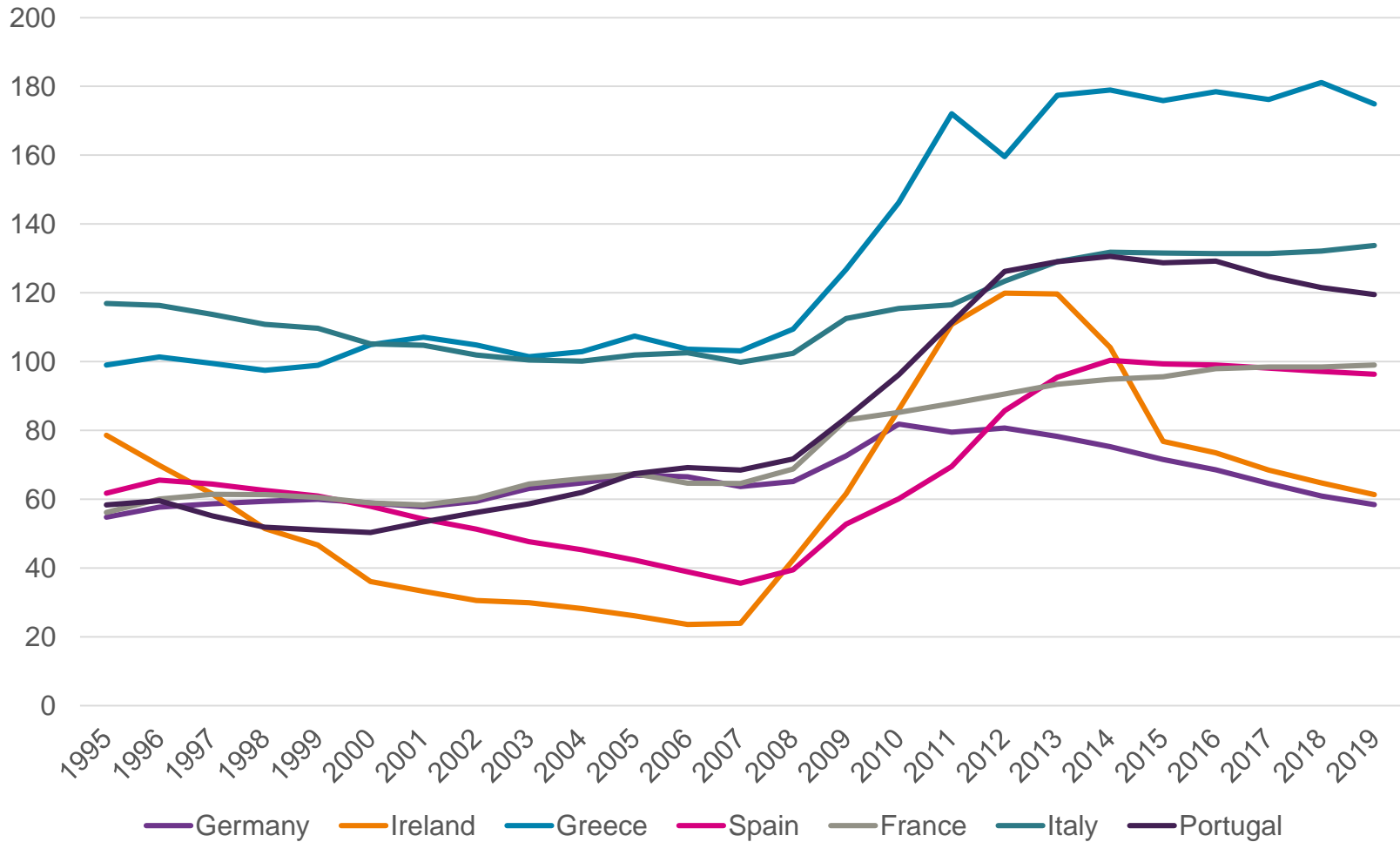
Bond Yield Convergence

Long-term yield spreads over German government bonds, month-end



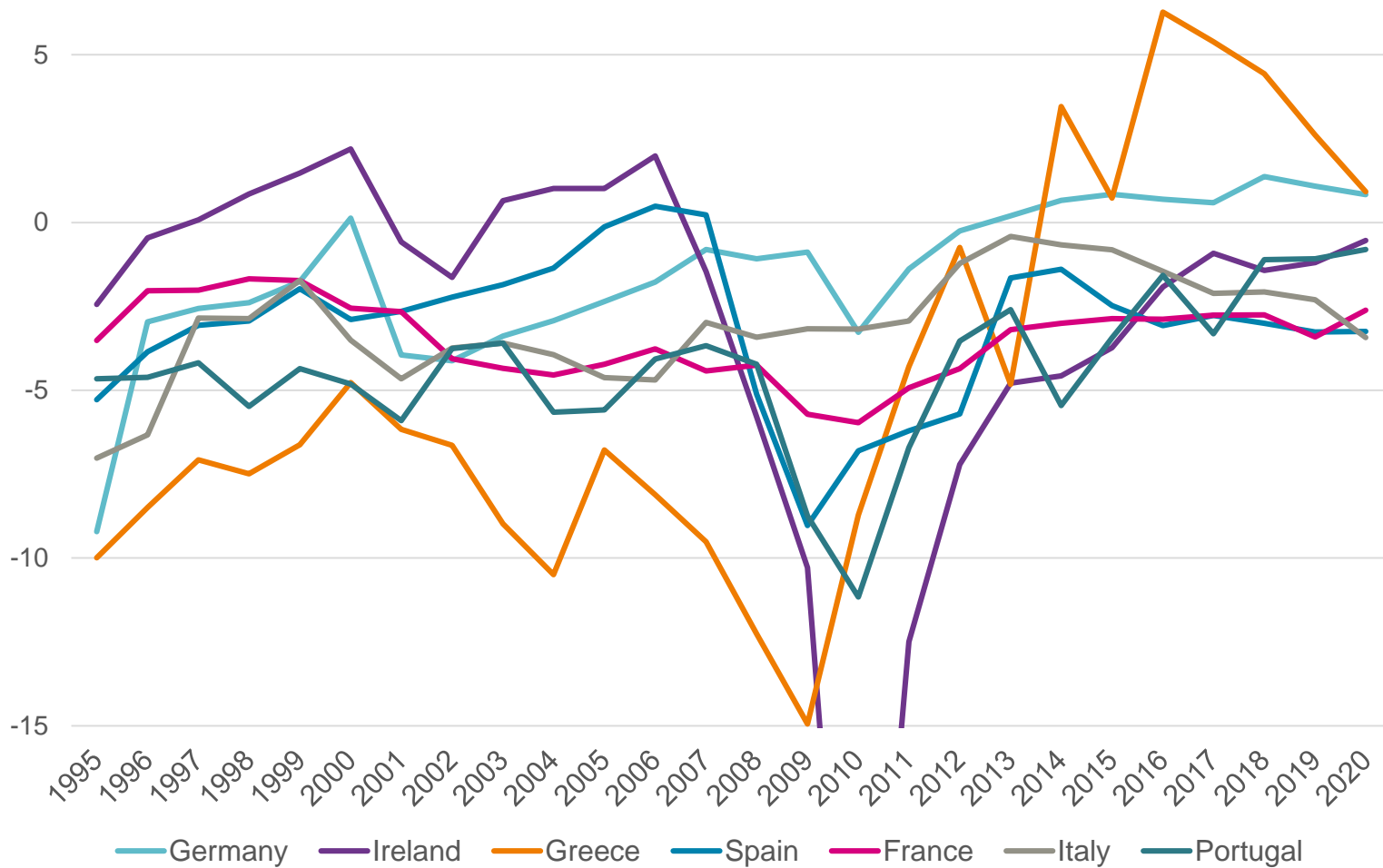
Source: moneyandbanking.com, based on ECB data

Debt-to-GDP ratio



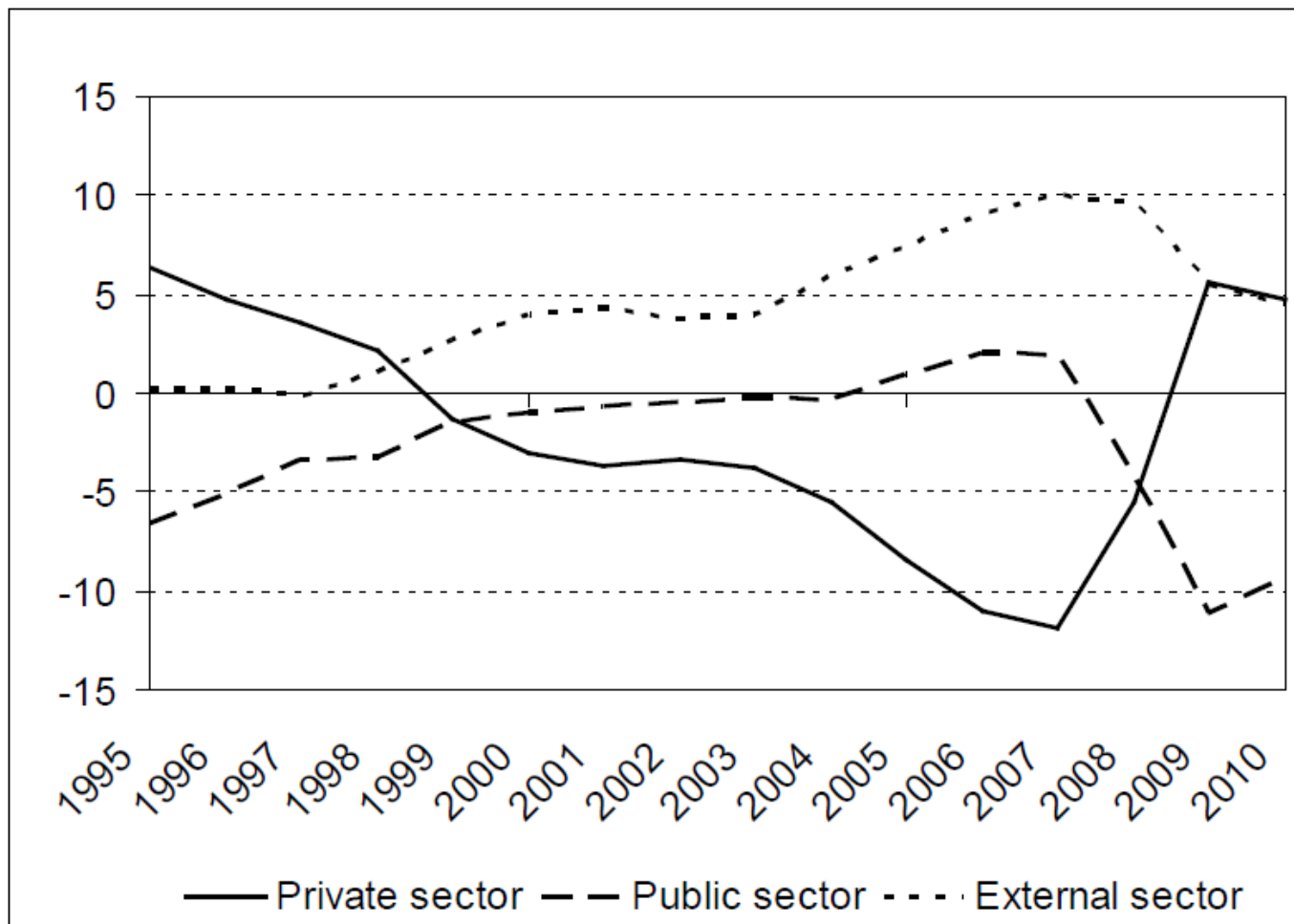
Source: AMECO

Cyclically Adjusted Budget Balance



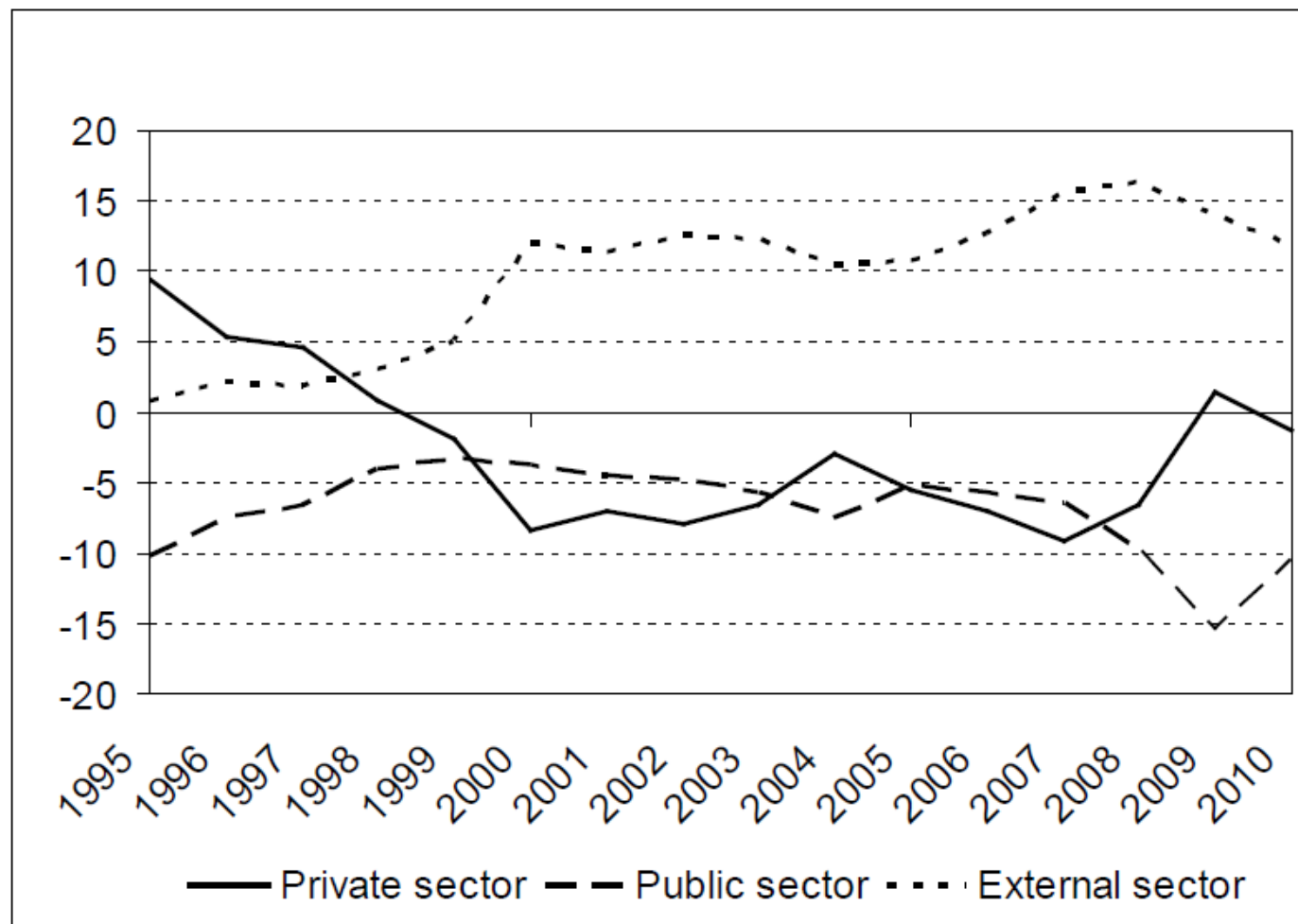
Source: AMECO

Sectoral Financial Balances - Spain



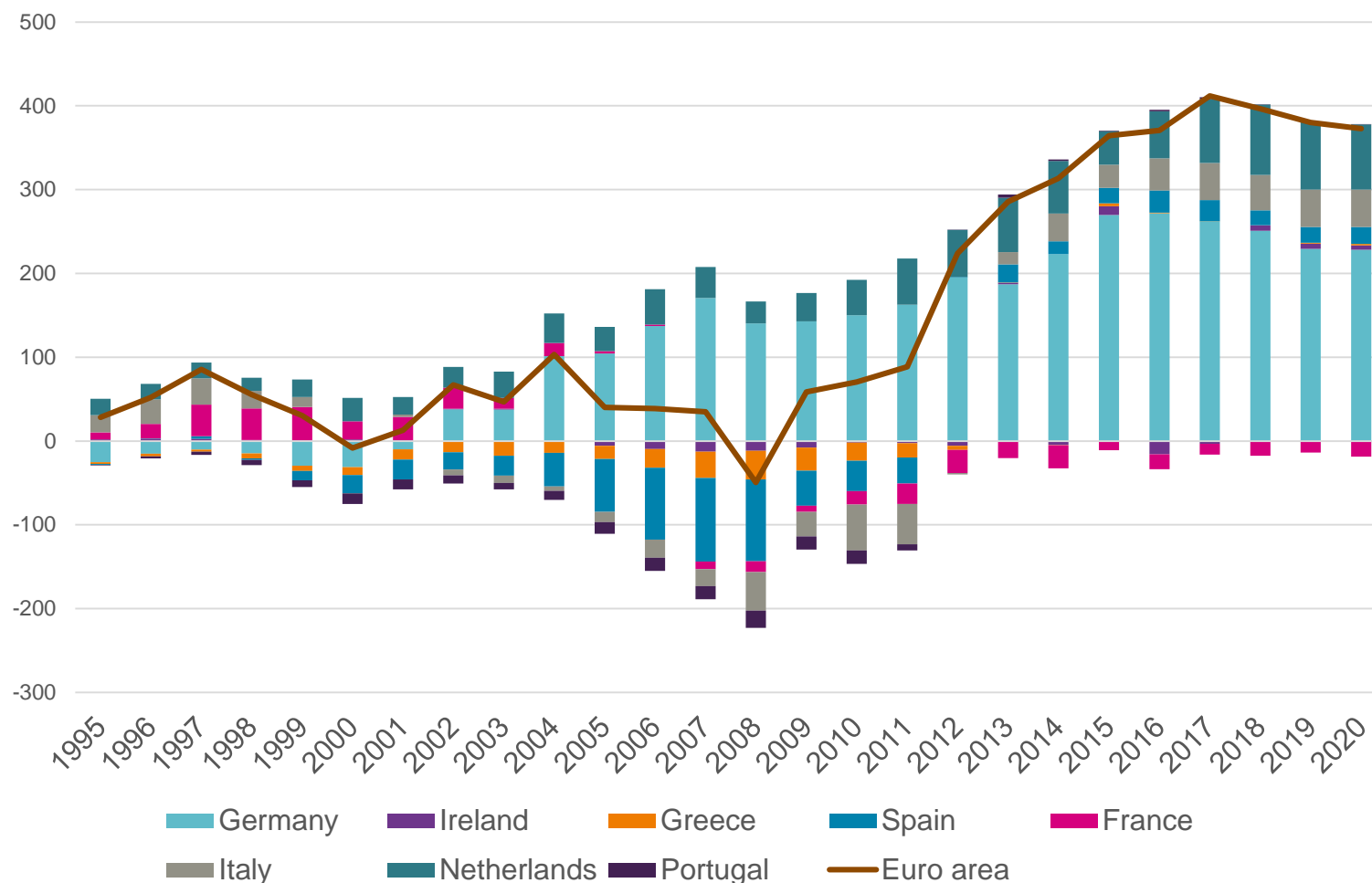
Source: Hein et al. (2012)

Sectoral Financial Balances - Greece



Source: Hein et al. (2012)

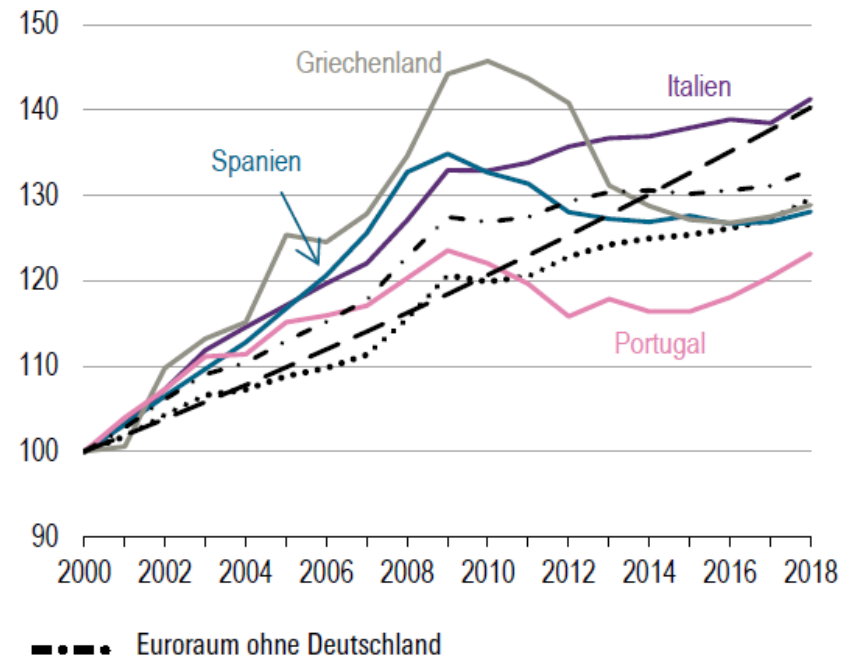
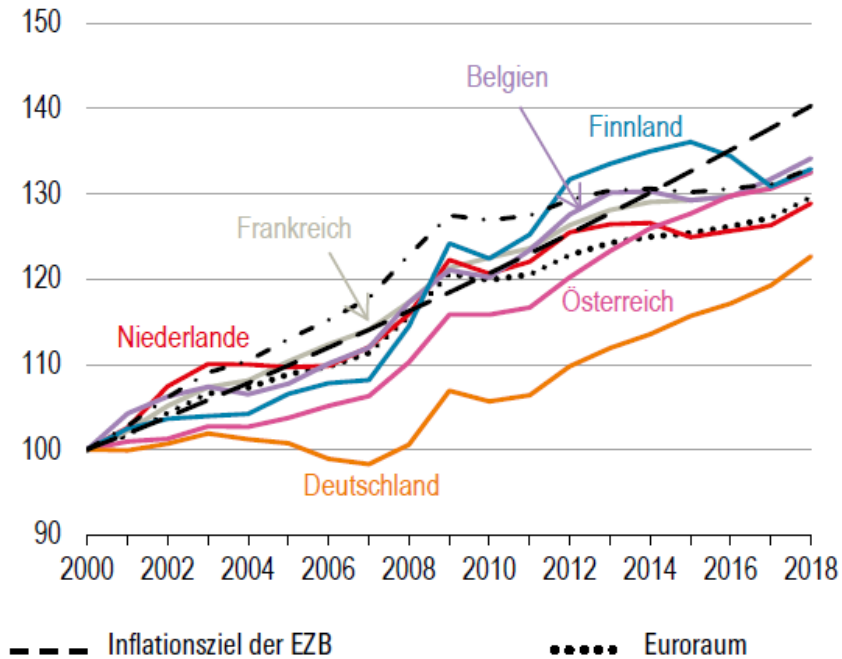
Net Lending (+) / Borrowing (-) Total Economy in Bn. Euro



Source: AMECO

Nominal Unit Labor Costs

2000=100



Quellen: Macrobond (Eurostat); Berechnungen des IMK (Datenstand 04.04.2019).



Source: Herzog-Stein et al. (2019)

Key imbalances indicators, 1999-2007 averages

	Consumption Boom, Deficit			Slow Growth, Deficit				Surplus	
	GRE	IRL	ESP	ITA	POR	EMU12	FRA	GER	NED
GDP	4.2	6.5	3.8	1.5	1.8	2.2	2.2	1.6	2.0
Domestic Demand*	4.7	5.7	4.8	0.8	1.9	2.1	2.7	0.7	2.0
Private Cons*	2.7	2.9	2.3	0.7	1.5	1.1	1.5	0.5	0.8
Public Cons*	0.8	0.9	0.9	0.4	0.4	0.4	0.4	0.2	0.8
Invest*	1.3	1.4	1.6	0.2	0.0	0.6	0.8	0.2	0.4
NX*	-0.6	1.4	-1.0	-0.2	-0.1	0.1	-0.4	0.9	0.5
NULC	3.1	3.1	3.0	2.5	2.7	1.6	1.7	0.0	2.2
HCPI	3.2	3.7	3.2	2.3	3.0	2.1	1.7	1.5	2.3
REER	1.5	2.2	1.6	1.5	1.2	--	0.6	-1.2	1.1

* Growth contributions to GDP

Source: Hein et al. (2012)

Debt-led growth and export-led growth

Two versions of a finance-dominated accumulation regime

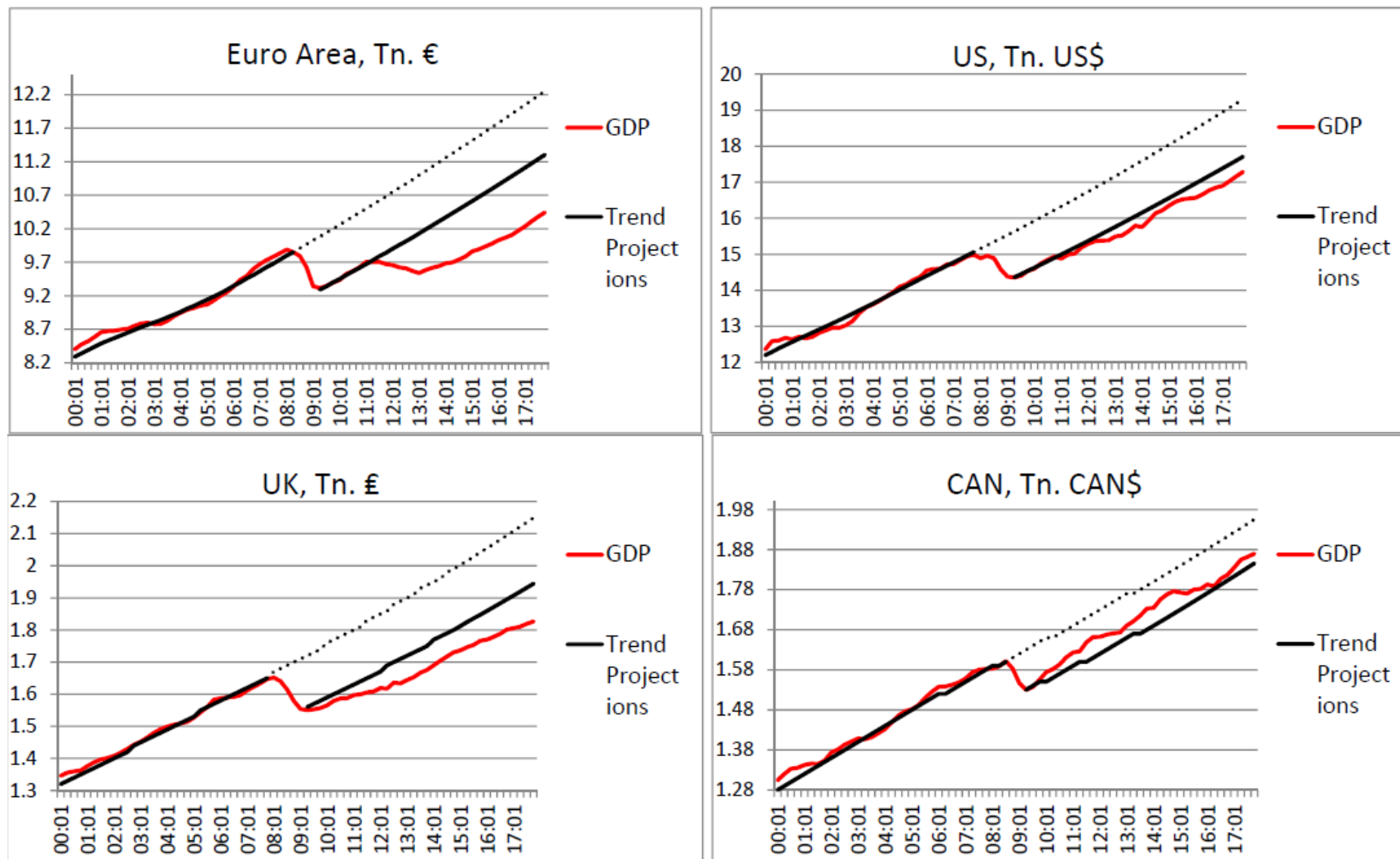
	<i>Debt-led growth</i>	<i>Export-led growth</i>
Center	US, UK, Australia, New Zealand	Germany, Japan, Netherlands, Norway, Sweden, Austria, Canada, Finland, Belgium, Denmark
Periphery	Spain, Greece, Turkey, Portugal, South Africa, Ireland, Hungary, Czech Rep., Slovakia, Estonia, Cyprus, Slovenia	China, Korea

The neglected role of CA imbalances and inflation differentials

- “To the question whether a single one-size monetary policy could fit all parties involved – be they national entities, social partners or economic actors – my answer was: ‘One size must fit all’. ...Today, **in light of the evidence gathered so far** in the euro area, I am more confident in saying: **One size does fit all!**” (Otmar Issing 2005)
- “in a monetary union, ... there are strong market-based forces that work in a stabilising manner. In particular, **if a country has lower than average inflation on account of weak demand, it will become more competitive in relation to other countries.** This tends to increase demand in that country (and reduce demand in others) over time. As has been shown in a number of recent studies, the **competitiveness (‘real exchange rate’) channel**, although slow to build up, eventually becomes the **dominating adjustment factor.**” (ECB 2005)
- “Divergent price and cost competitiveness developments might reflect **normal** and even **desirable responses to catching-up processes** and country specific shocks. However, they may also be an **indication of labour cost developments that are not economically justified** and which in turn may reflect a lack of price and wage flexibility or overly optimistic expectations regarding future income growth in some countries.” (ECB 2007)

EMU CRISIS MANAGEMENT

This is something that needs to be explained!



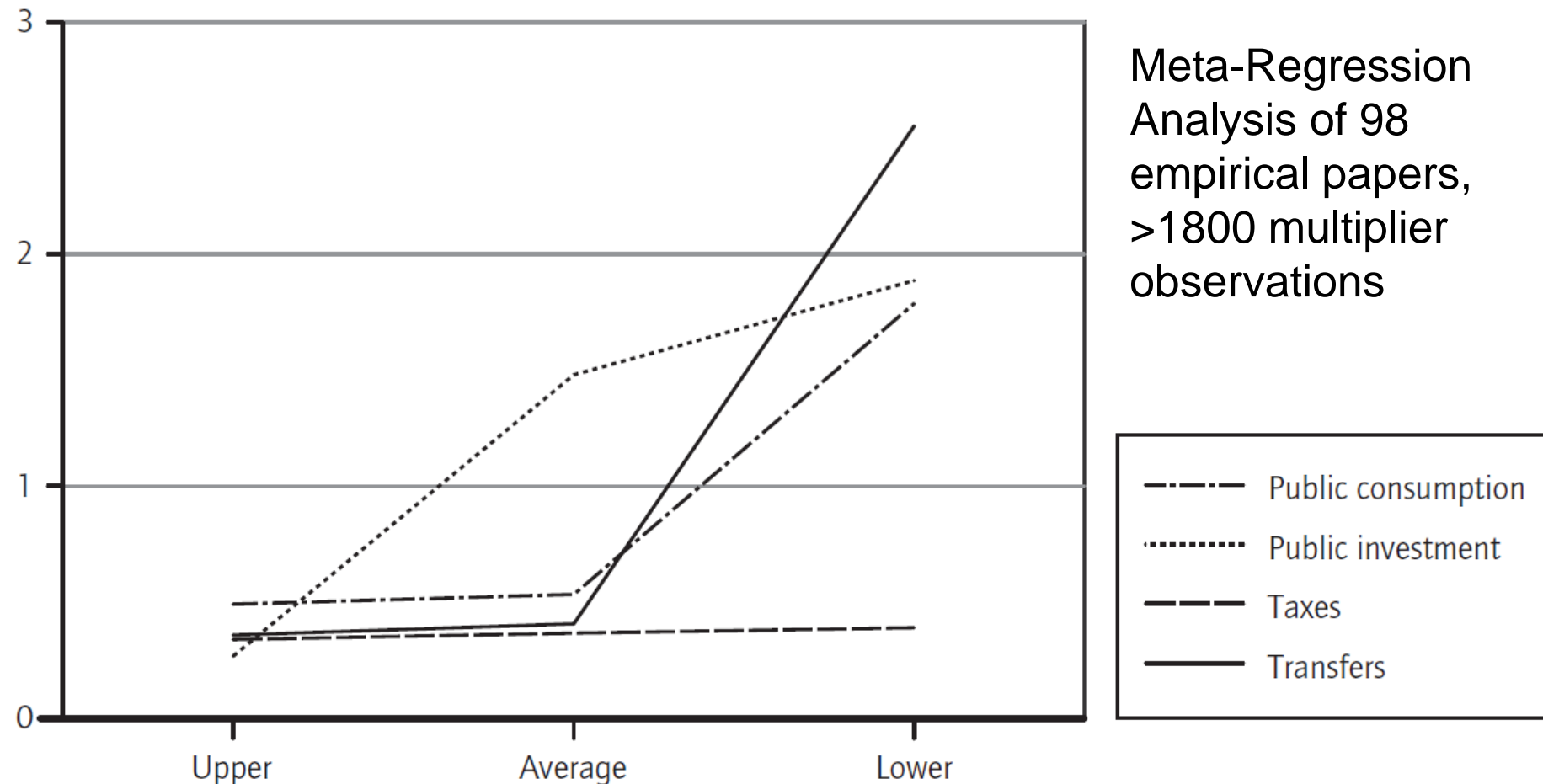
Fiscal Policy Vices and Virtues

- November 2008: European Economic Recovery Plan" (EERP): **coordinated fiscal stimulus** of 1.5 per cent of EU27 GDP should be implemented in 2009 (SGP escape clause) → But too little, too late
- From 2010: Strong push towards **austerity** in programme countries, but also in many core countries
- June 2010: Foundation of EFSF (since 2012 ESM) **bailout fund** with lending capacity of €700 Bn, but strict **conditionality** (Memoranda of Understanding (MoU))
- December 2011/March 2012: Fiscal compact even **tightening the fiscal rules**: debt brakes of the German flavour become part of SGP. 0.5% „structural“ deficit target
- 2013/2014: Reinterpretation of SGP by EUCO: **easing of austerity**
 - Accepting higher deficits for countries in recession
 - Widening of structural reform clause
 - Investment clause
 - Juncker Plan (EFSI)

The Confidence Fairy

- Jean-Claude Trichet (2010) **Stimulate no more - it is now time for all to tighten:** “My understanding is that an overwhelming majority of industrial countries are now in those uncharted waters, where **confidence** is potentially at stake. **Consolidation is a must in such circumstances.**” *Financial Times*, 22. Juli 2010
- Wolfgang Schäuble (2010) **Expansionary fiscal consolidation:** “All the eurozone governments need to demonstrate convincingly their own **commitment to fiscal consolidation** so as to restore the **confidence of markets**, not to speak of their own citizens.” *Europe’s World*, 1. Oktober 2010
- Academic work „substantiating“ these views:
 - Reinhard & Rogoff (2010),
 - Alesina et al. (several): **spending cuts are expansionary**
 - General view at European Commission, ECB and IMF:
 - Fiscal multipliers ~ 0.5 in the short run, 0 in the long run

Regime dependent fiscal multipliers



Source: Gechert and Rannenberg (2018)

Consolidation measures in % of 2010 GDP

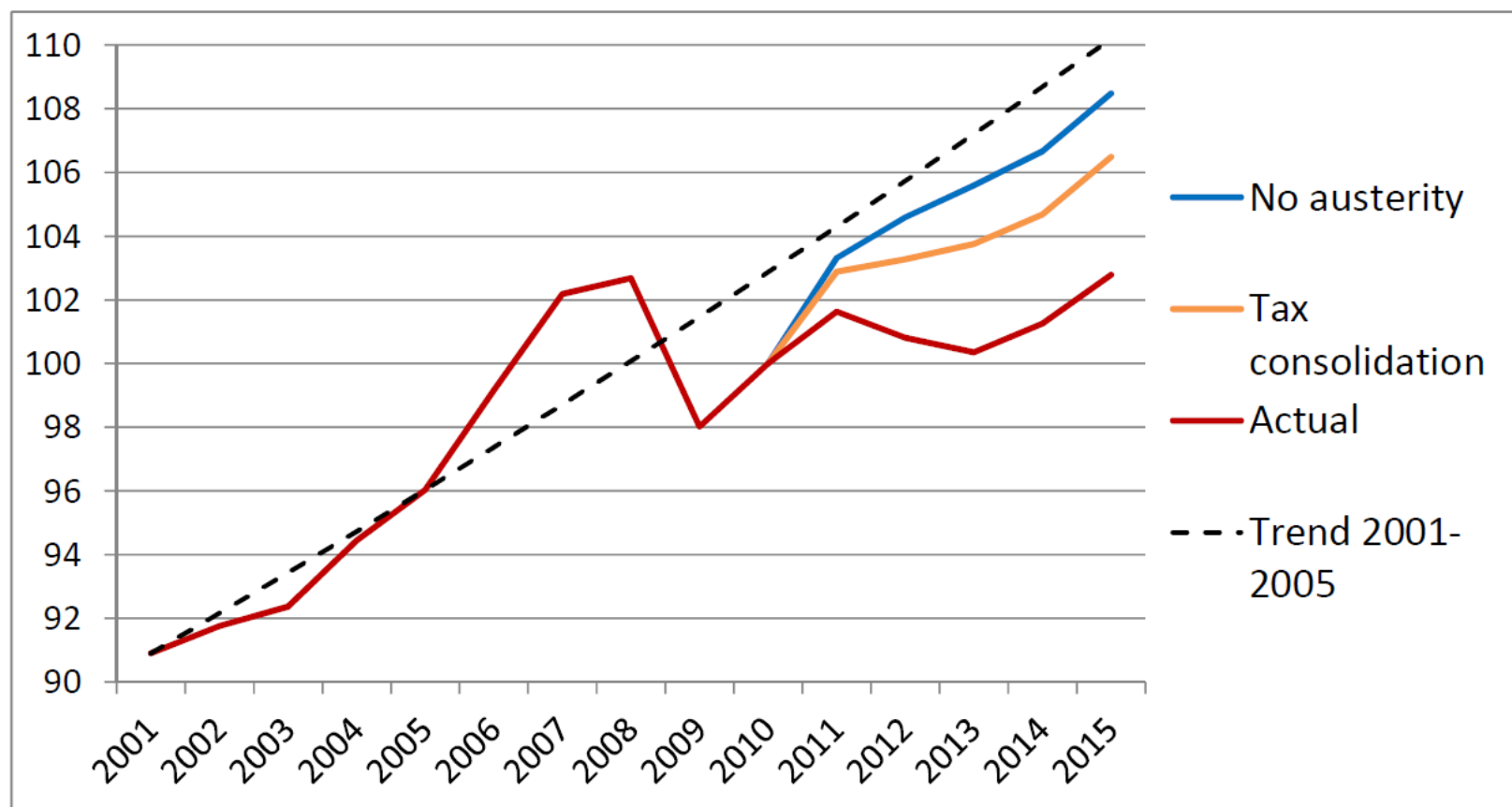
Euro Area

	2011	2012	2013	2014	2015
Total revenue	0.5	1.6	2.3	2.5	2.5
Total expenditure	0.7	1.3	1.8	1.8	2.0
All measures	1.2	3.0	4.1	4.3	4.5

Greece

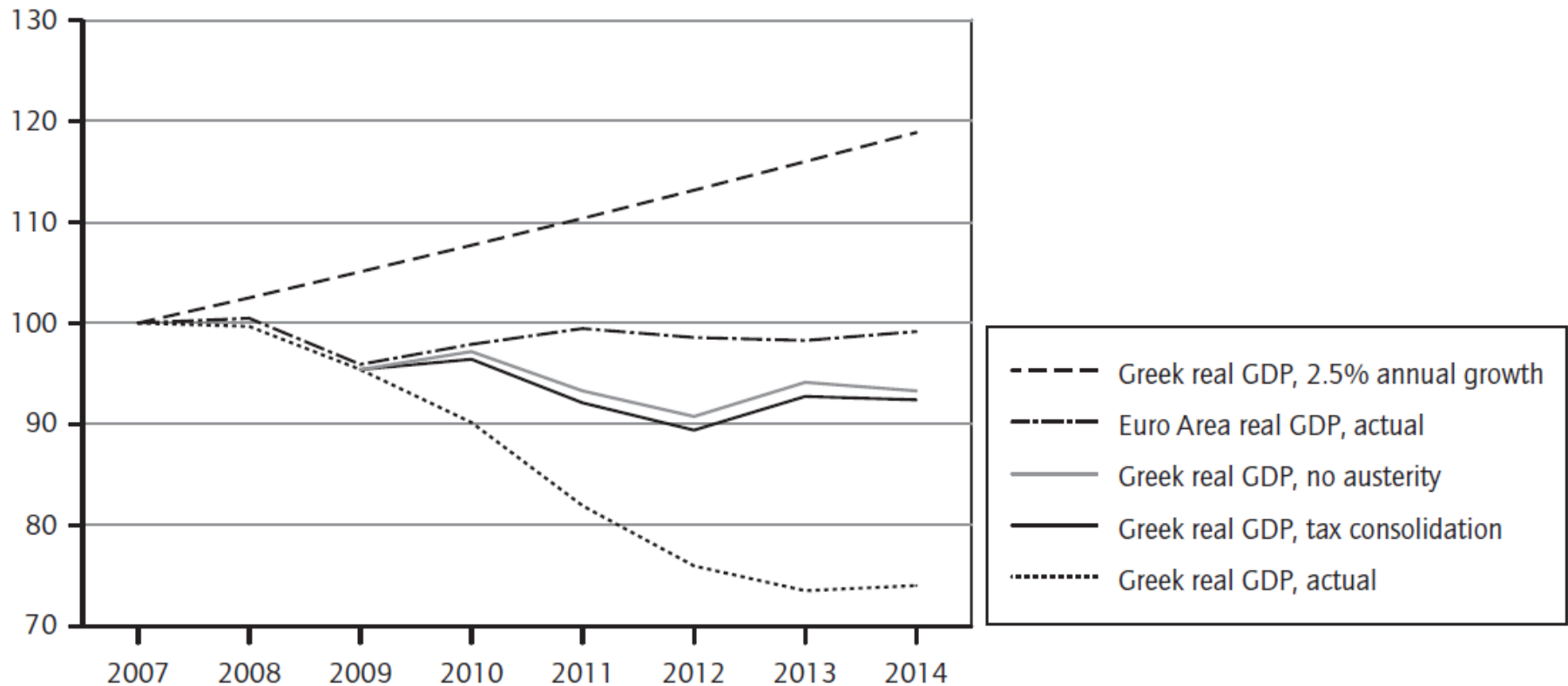
	2010	2011	2012	2013	2014
Total revenue	4.2	8.2	10.5	11.9	12.1
Transfers	0.6	0.5	1.1	3.1	3.0
Government consumption expenditure	2.3	4.7	6.1	7.6	7.8
Government gross fixed capital formation	0.9	1.4	1.4	0.9	0.7
Total expenditure	3.8	6.6	8.6	11.6	11.5
All measures	8.0	14.7	19.1	23.5	23.6

GDP effects of austerity for the Euro Area



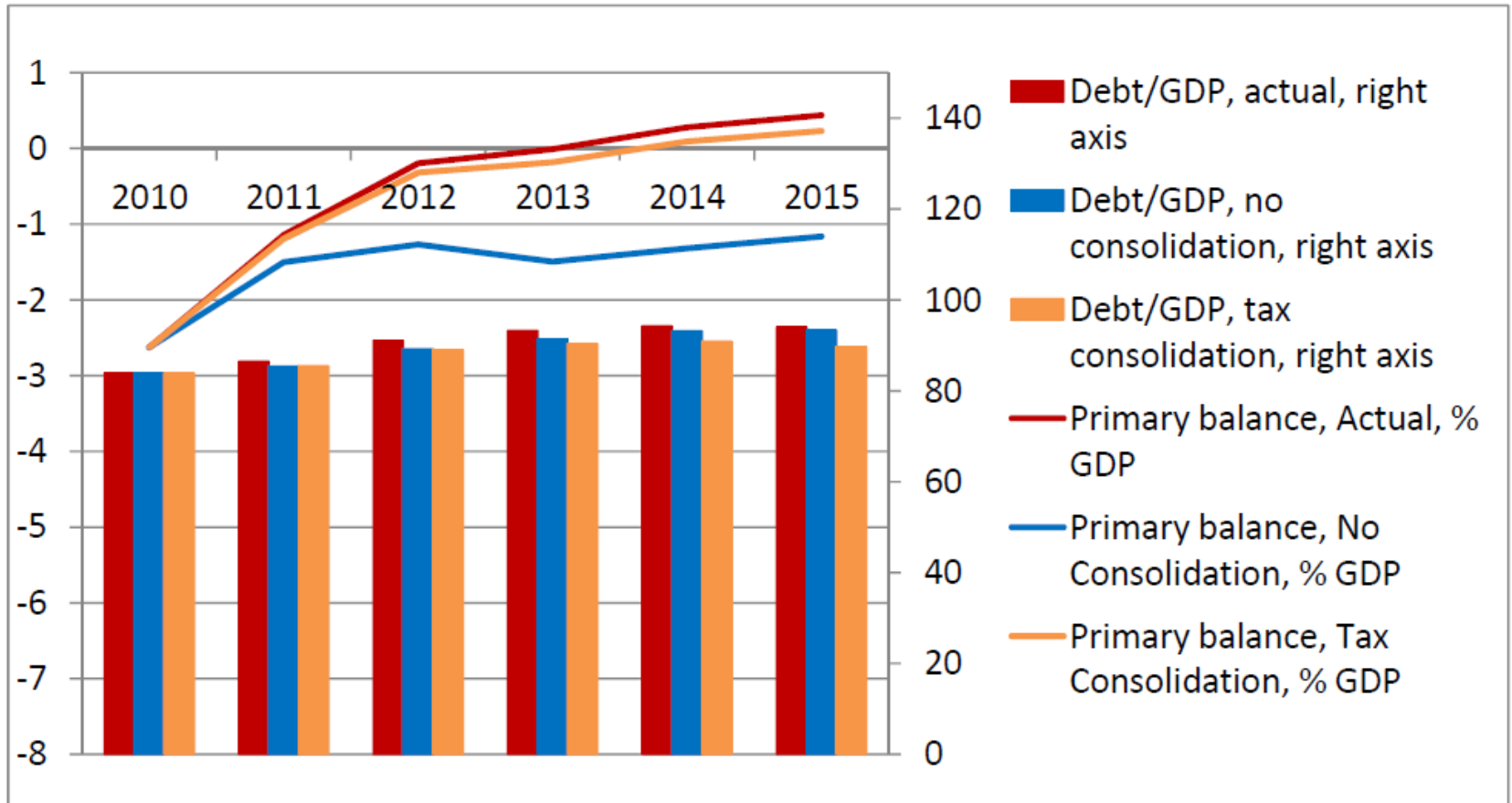
Source: Gechert et al. (2015)

GDP effects of austerity for Greece



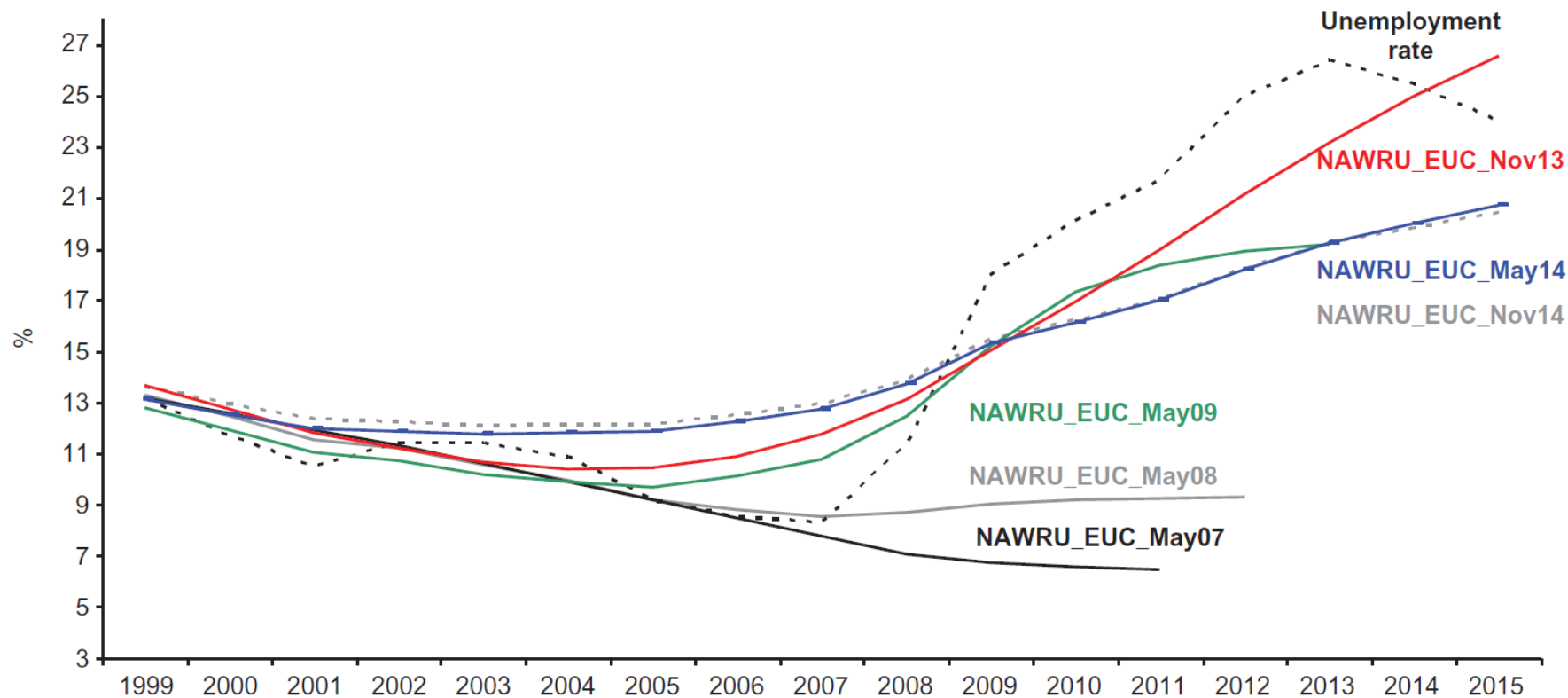
Source: Gechert and Rannenberg (2016)

Effects on public debt and primary balance



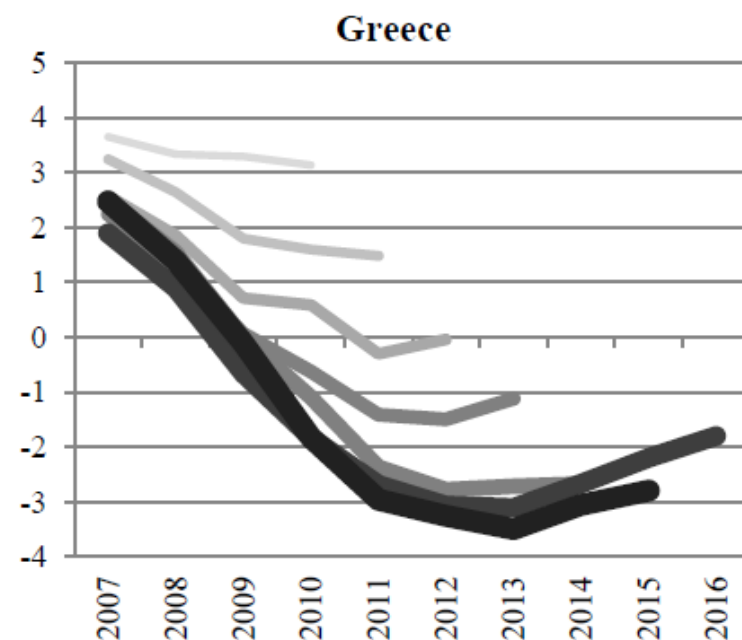
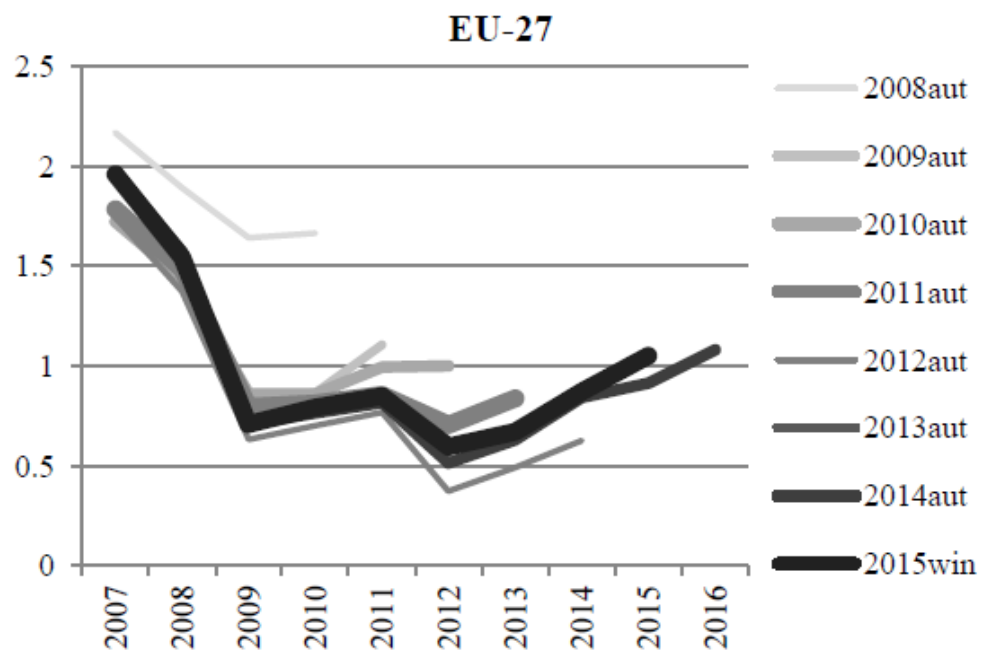
Source: Gechert et al. (2015)

Issues in measuring fiscal stance: Structural Deficit, NAIRU and Potential Output

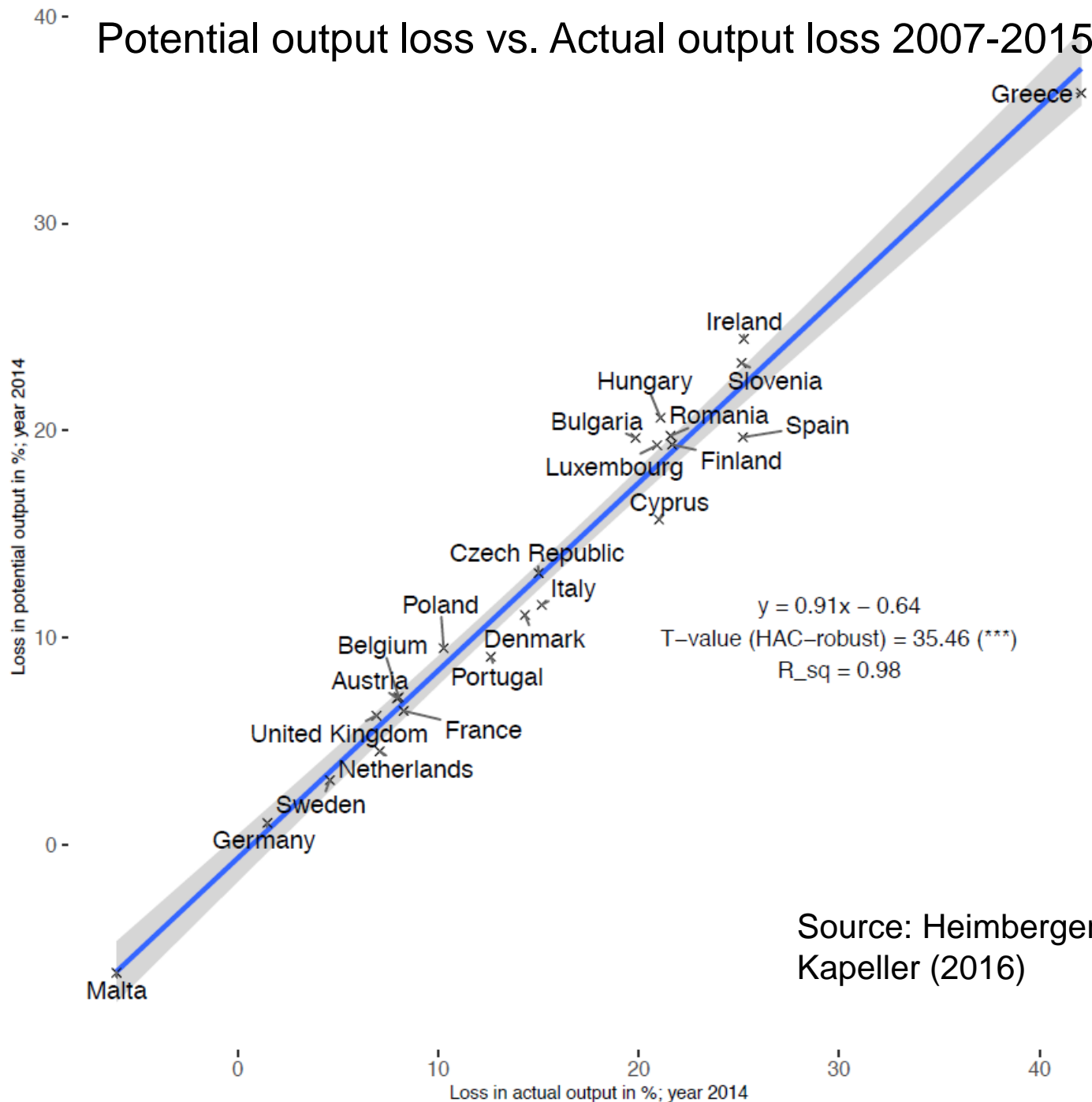


Source: Gechert et al. (2016)

Potential output estimates at different vintages

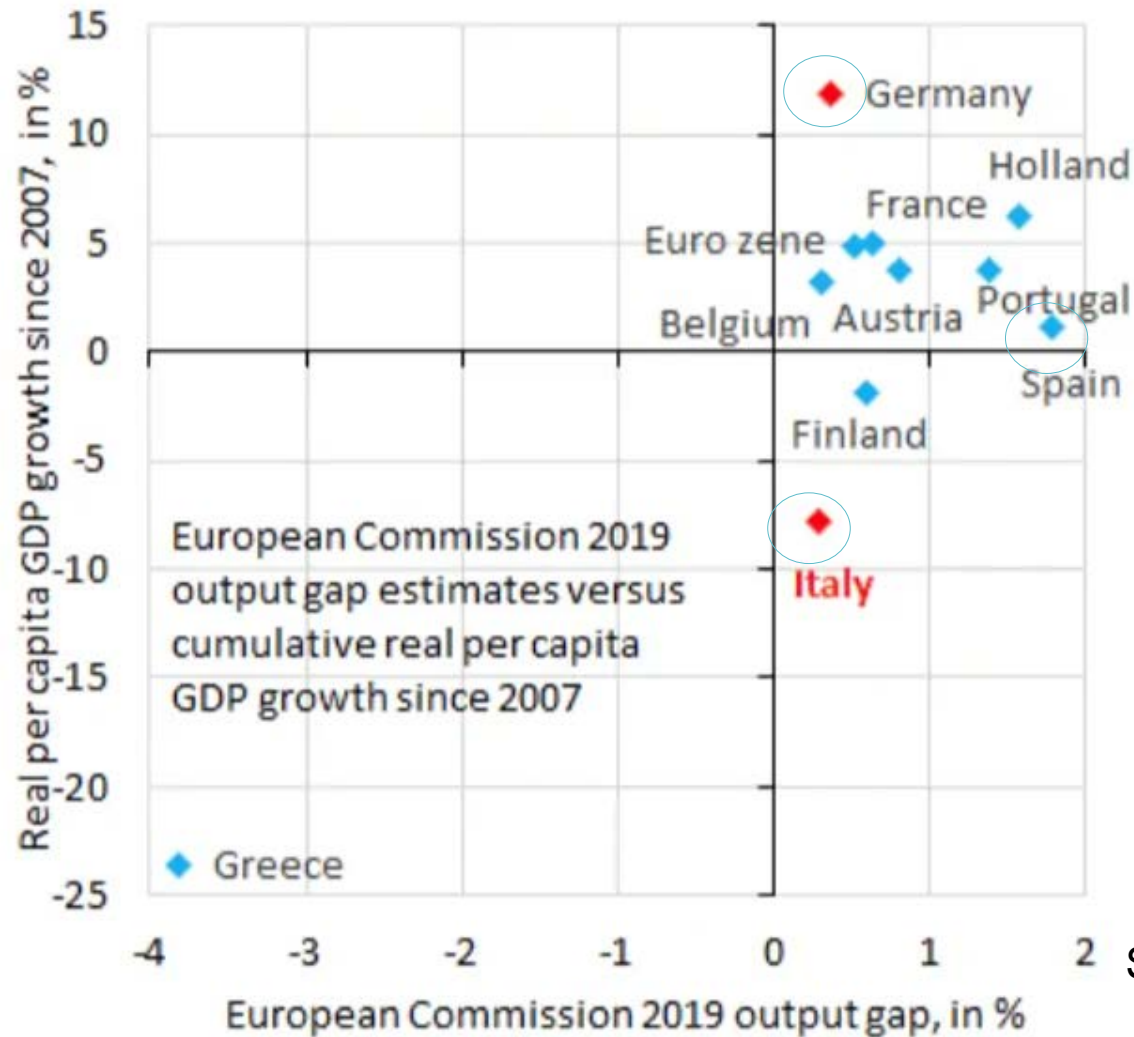


Potential output loss vs. Actual output loss 2007-2015



Source: Heimberger and Kapeller (2016)

„Output gap nonsense“



Source: Tooze (2019)

Structural Deficit

$$SB = B - CB$$

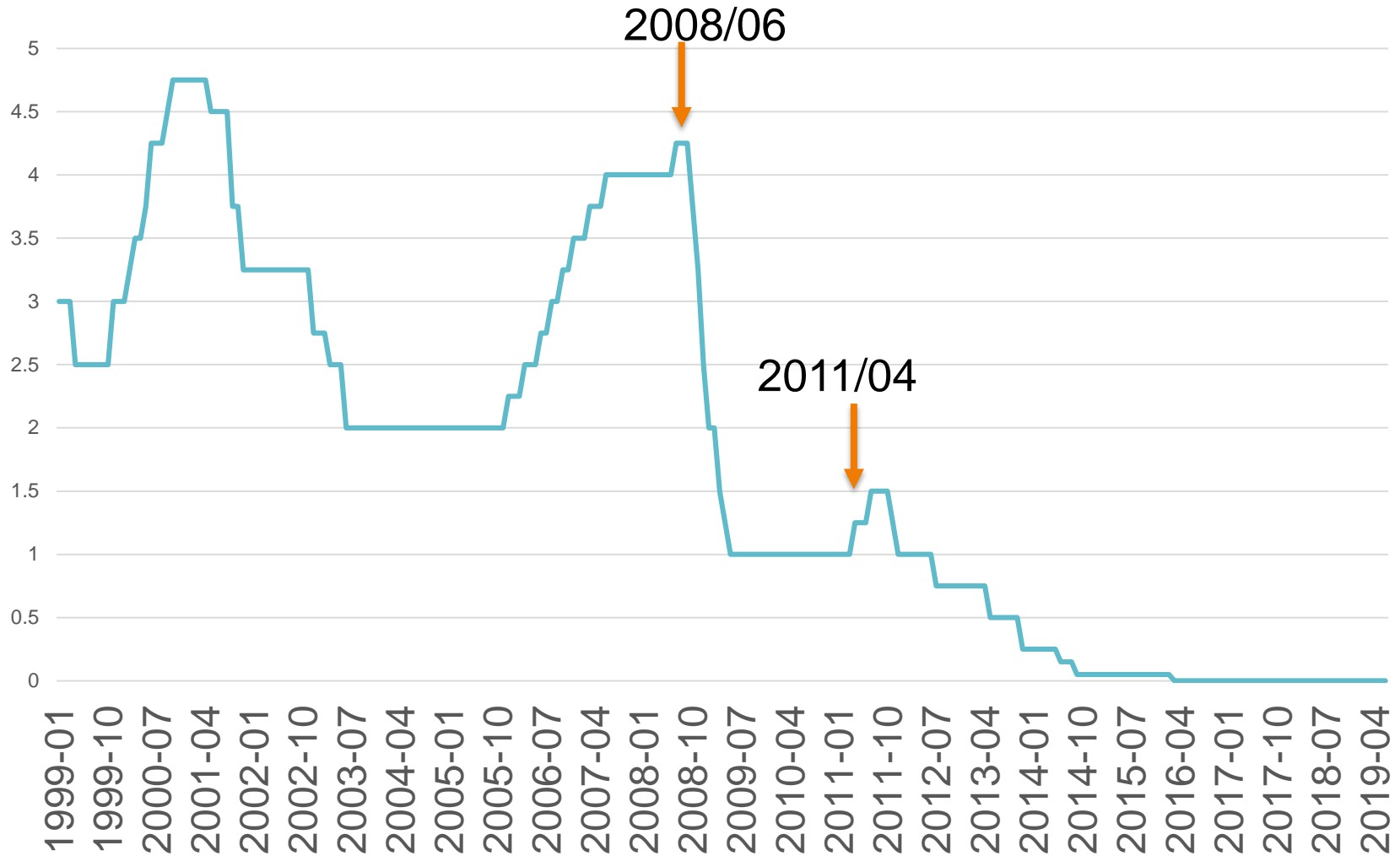
$$SB = B - \varepsilon (Y - Y_{pot})$$

- **Cyclical adjustment** of budget balances in principle a good thing to **allow for automatic stabilizers** under fiscal rules
- But reference to potential output problematic
 - General end-point bias
 - Strong revisions of Y_{pot} in face of long swings
- Cyclical component is smaller than it should be
- **Weakening** of automatic stabilizers
- **Procyclical** fiscal stance

Monetary Policy (Vices and Virtues)

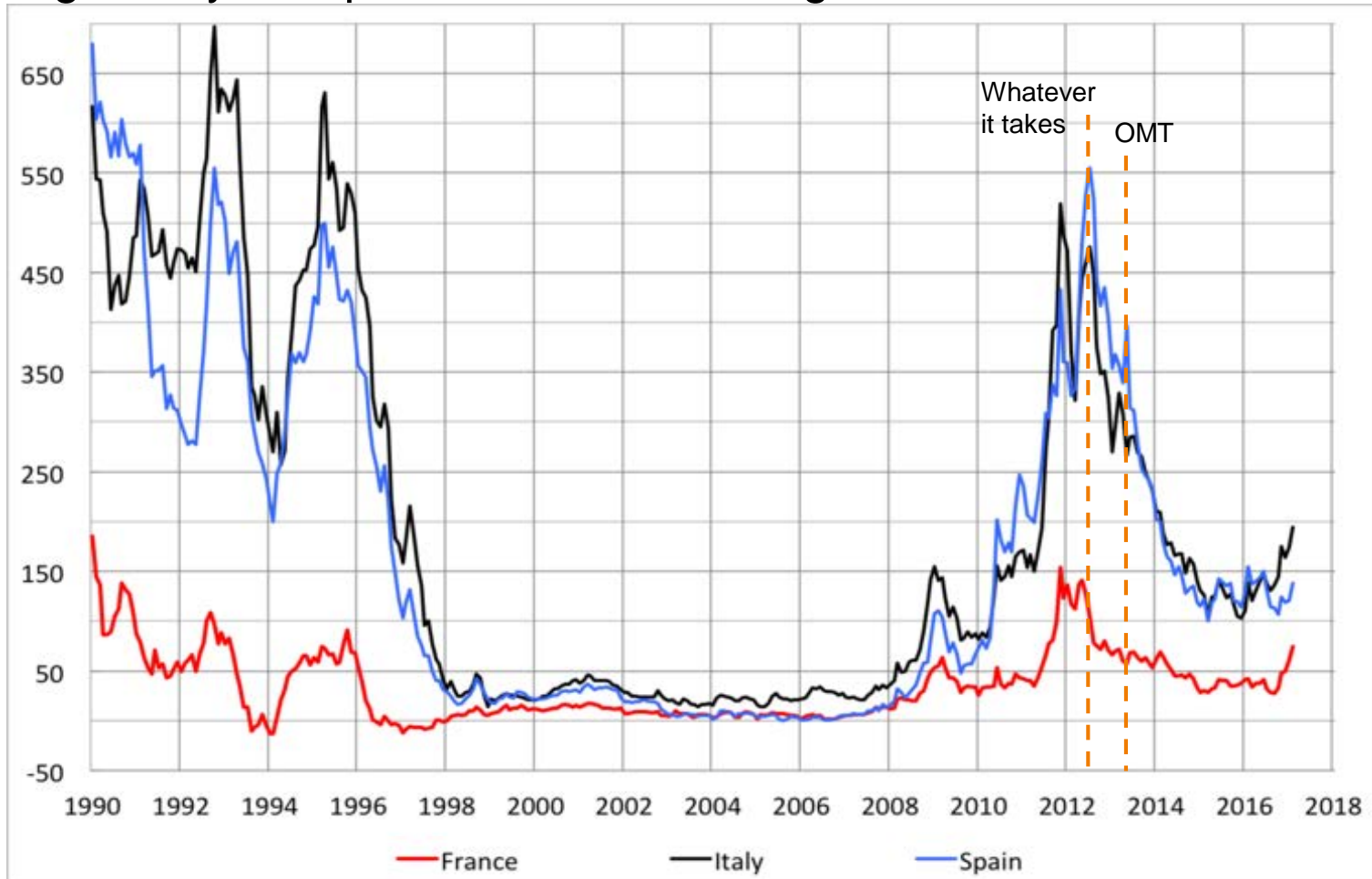
- Interest rate hikes prior to crises (2008, 2011)
- Whatever it takes, OMT (2012) → LOLR light, but conditionality
- TLTRO I-III (2014,16,19), rewarding lending practices
- Greece ELA cap 2015
- Constantly asking for more fiscal help (even if maybe for reasons of „fiscal dominance“)

Bad timing for rate hikes



„Whatever it takes“ and OMT

Long-term yield spreads over German government bonds, month-end



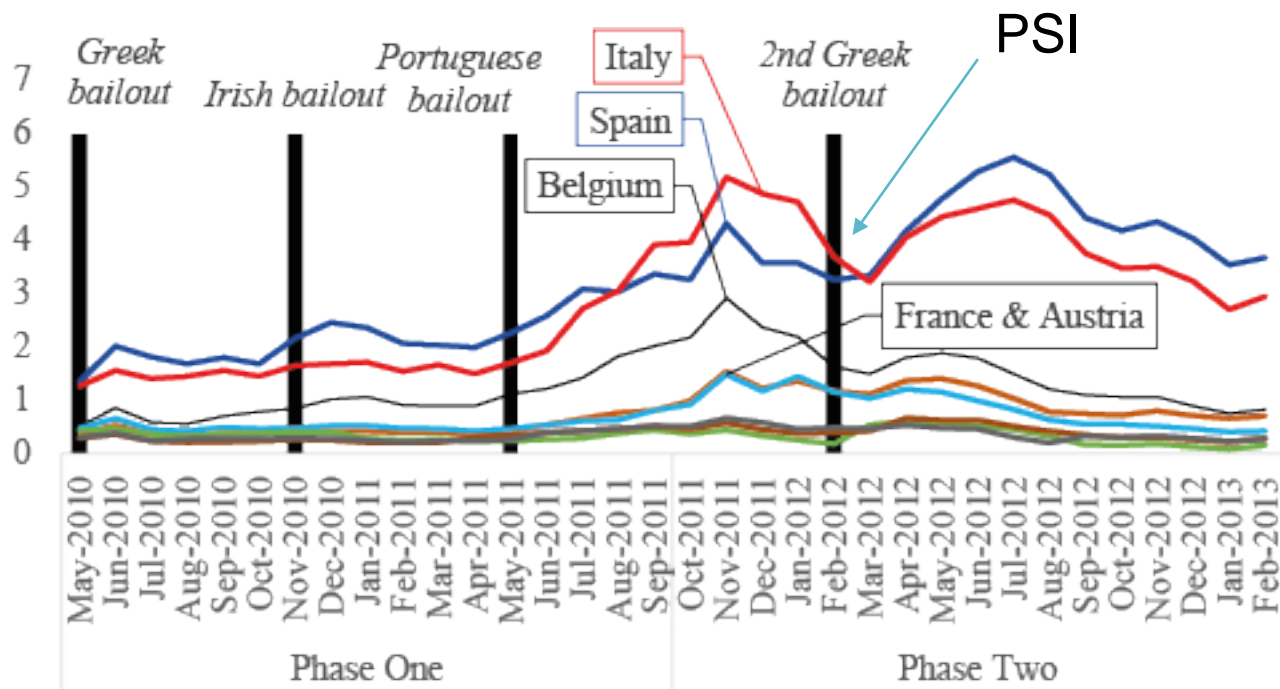
Source: moneyandbanking.com, based on ECB data

Macroeconomic Imbalance Procedure

- Step in the right direction in 2011
- Acknowledgment of
 - current account imbalances,
 - external debt and
 - private debt positions
- But: asymmetric floor and ceiling for CA: **-4%, but +6%** (to allow GER to fit the criteria in the first place, but it managed to miss it still)
- Essentially **no bite** as compared to the SGP

On Private Sector Involvement

- Plausible **fairness concerns** of crisis resolving: make private creditors pay their fair share.
- PSI in Greece agreed in July 2011 as part of the 2nd bailout
- But this had **huge contagion effects** on the other Euro periphery countries! Spreads increased to new records again



Source: Baldwin & Giavazzi (2015)

EMU CRISIS NARRATIVES

The „mainstream consensus view“ (Baldwin & Giavazzi 2015, Eds.)

Crisis Triggers and Amplifiers

- Eurozone crisis triggered by global financial crisis. → **Sudden stop**
- “Revelation of the **Greek deficit deceit**”
- Thinly capitalized banks, extremely large compared to their countries → “double drowning scenario.”
- Doom loop: “The key element in this mechanism is that Eurozone **banks** are heavily **invested** in the debt of their **own government**.”
- “Governments who got in trouble had **no lender of last resort**.”
- “Nothing in the Eurozone **institutional infrastructure** was prepared for a crisis on this scale.”
- “Indeed, judging from market reactions, **each policy intervention** made things worse.”
- **Rigidity** of factor and product markets
- **Procyclical fiscal tightening** → mainly harmful due to increasing **taxes**

The „mainstream consensus view“ (Baldwin & Giavazzi 2015, Eds.)

Underlying Causes

- „Eurozone crisis should **not** be thought of as a **sovereign debt crisis**.“
- “Extremely unoriginal” crisis cause: too much public and private **external borrowing**, and in particular **unproductive uses** (housing, govt consumption)
- This drove up **wages and costs** impairing competitiveness positions.
- “By contrast, all the core nations except Netherlands and Luxembourg had **inflation below the norm, especially Germany**.“
- “**low policy rates** adopted by advanced countries’ central banks, **financial innovations** (such as new types of securitisation) and **shifting beliefs** about risk levels and risk absorption capacity combined to foster an extraordinary boom in international capital flows.”
- “When it comes to investment, the **core nations tended to underinvest at home** (compared to the Eurozone average), while Greece, Ireland, Italy, Portugal and Spain tended to overinvest.”
- “Sadly, the substantial **lower risk premiums**... that came with the euro implied strong booms but **too little economic reforms**.“

The „mainstream consensus view“ (Baldwin & Giavazzi 2015, Eds.)

„Causes of the causes“

- „Divergence of liability and control (Feld et al. 2015 in Baldwin/Giavazzi) → SGP not enforcing enough
- „Missing lender of last resort“ (DeGrauwe 2015 in Baldwin/Giavazzi)
- Institutional heterogeneity (Papaioannou 2015 in Baldwin/Giavazzi)
- Failure to control excessive bank leverage

An alternative crisis narrative

There is much to agree with this *new* „mainstream consensus“, but...

- The detrimental role of surplus countries (particularly GER) is still downplayed
- The **asymmetric adjustments** that took place **since 2010** are ignored
- The **procyclicality** of the **fiscal rules** framework is still not recognized
- Particular harmfulness of spending cuts not recognized
- The **hysteretic damage** of sheer policy mistakes that has been done to the living generation in crisis countries remains largely downplayed (youth unemployment, long-term unemployment, brain drain, political outfall)

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