Europe and the Euro

Enrico Marelli • Marcello Signorelli

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Integration, Crisis and Policies

Foreword by Paul De Grauwe

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Enrico Marelli
University of Brescia
Brescia, Italy

Marcello Signorelli
University of Perugia
Perugia, Italy

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To European people and future generations

A unified Europe has a meaning for civilization that is deeper even than security and peace.
Europe was the source of the cultural achievements from which we all benefit [. . .]
WE ARE NOT UNITING STATES, WE ARE UNITING HUMAN BEINGS.

(Jean Monnet, 'The United States of Europe', Washington, 30 April 1952)

Foreword

The sovereign debt crisis that erupted in 2010 exposed the design failures of the Eurozone. These have long been known. Right from the start of the Eurozone many economists warned that these design failures would lead to problems and conflicts within the currency union, and that the Eurozone in the end would fall apart if these failures were not corrected.

'Visionary' European politicians brushed aside the warnings from economists in the 1990s that the euro is based on a flawed construction. Nothing would stop their great monetary dream, certainly not the objections of down-to-earth economists. What are these design failures?

The Eurozone Is Not an Optimal Currency Area

The European monetary union (EMU) lacked a mechanism that can stop divergent economic developments between countries. Some countries experienced a boom, others a recession. Some countries improved their competitiveness, others experience a worsening. These divergent developments led to large imbalances, which crystallised in the fact that some countries built up external deficits and other external surpluses.

When these imbalances had to be redressed, it appeared that the mechanisms to redress the imbalances in the Eurozone (internal devaluations) are very costly in terms of growth and employment, leading to social and political upheavals. Countries that have their own currency and that are faced with such imbalances can devalue or revalue their currencies. In a monetary union, countries facing external deficits are forced into intense expenditure reducing policies that inevitably lead to rising unemployment. This problem has been recognised by the economists that pioneered the theory of optimal currency areas (Mundell, 1961; McKinnon, 1963; Kenen, 1969). Later important contributions include Bayoumi and Eichengreen (1993) and Krugman (1993).

The standard response derived from the theory of optimal currency areas is that member countries of a monetary union should do structural reforms so as to make their labour and product markets more flexible. By increasing flexibility through structural reforms the costs of adjustments to asymmetric shocks can be reduced and the Eurozone can become an optimal currency area. This has been a very influential idea and has led Eurozone countries into programmes of structural reforms.

It is often forgotten that although the theoretical arguments in favour of flexibility are strong, the fine print of flexibility is often harsh. It implies wage cuts, less unemployment benefits, lower minimum wages, easier firing. Many people hit by structural reforms, resist and turn to parties that promise another way to deal with the problem, including an exit from the Eurozone. From an economic point of view flexibility is the solution. From a social and political point of view flexibility is the problem.

There is a way to reduce the costs of the adjustment to imbalances in a monetary union if this adjustment can be made to operate symmetrically. Thus, if the inevitable austerity by the deficit countries can be compensated by fiscal stimulus in the surplus countries, the negative aggregate demand effects in the former can be compensated by positive demand effects in the latter. Such a symmetric adjustment mechanism did not operate in the Eurozone after 2010, when the large external imbalances in the Eurozone were exposed. The deficit countries were forced into austerity while the surplus countries tried to balance their budgets. The result has been to create a deflationary bias in the Eurozone.

Contrary to what was promised, the EMU has failed dismally in delivering on these promises, that is, that EMU would lead to more economic growth and employment. The opposite has occurred. Member countries of the Eurozone have on average experienced less growth and more unemployment than the EU countries that decided to stay out of the Eurozone. Such an outcome, if maintained, undermines the social consensus in favour of a monetary union.

Fragility of the Sovereign in the Eurozone

When the Eurozone was started, a fundamental stabilising force that existed at the level of the member states was taken away from these countries. This is the lender of last resort function of the central bank. Suddenly, member countries of the monetary union had to issue debt in a currency they had no control over. As a result, the governments of these countries could no longer guarantee that the cash would always be available to roll over the government debt. Prior to entry in the monetary union, these countries could, like all stand-alone countries, issue debt in their own currencies thereby giving an implicit guarantee that the cash would always be there to pay out bondholders at maturity. The reason is that as stand-alone countries they had the power to force the central bank to provide liquidity in times of crisis.

What was not understood when the Eurozone was designed is that this lack of guarantee provided by Eurozone governments in turn could trigger self-fulfilling liquidity crises (a sudden stop) that would degenerate into solvency problems. This is exactly what happened in countries like Ireland, Spain and Portugal.[1] When investors lost confidence in these countries, they massively sold the government bonds of these countries, pushing interest rates to unsustainably high levels. In addition, the euros obtained from these sales were invested in 'safe countries' like Germany. As a result, there was a massive outflow of liquidity from the problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at reasonable interest rate.

This liquidity crisis in turn triggered another important phenomenon. It forced countries to switch-off the automatic stabilisers in the budget. The governments of the problem countries had to scramble for cash and were forced into quick austerity programmes, by cutting spending and raising taxes. A deep recession was the result. The recession in turn reduced government revenues even further, forcing these countries to intensify the austerity programmes. Under pressure from the financial markets and the creditor nations, fiscal policies became procyclical pushing countries further into a deflationary cycle. As a result, what started as a liquidity crisis in a self-fulfilling way degenerated into a solvency crisis.

The Eurozone crisis that emerged after 2010 was the result of a combination of two design failures. First, booms and busts continued to occur at the national level, leading to large external imbalances. The lack of a smooth mechanism to correct for these imbalances created large economic and social costs. Second, the stripping away of the lender of last-resort support of the member state countries allowed liquidity crises to emerge when the booms turned into busts. These liquidity crises then forced countries to eliminate another stabilising feature that had emerged after the Great Depression, that is, the automatic stabilisers in the government budgets. As a result, some countries were forced into bad equilibria.

As economists, we should think harder of what happens to political systems when countries are forced into bad equilibria. As we have seen, in many countries where this happened, the political systems were badly shaken and extreme parties either increased in importance or came to power. In several of these countries, the newly emerging political parties exhibit an open hostility to the monetary union and promise a better future outside the Eurozone.

This book of Enrico Marelli and Marcello Signorelli comes at the right time. We now know more or less what the nature of the Eurozone crisis is. And we can start thinking about the ways to go forward to make the Eurozone sustainable in the long run. Enrico Marelli and Marcello Signorelli provide an excellent analysis of the causes of the Eurozone crisis and of the strategies that we will have to follow to ensure the survival of the euro.

London School of Economics, UK Paul De Grauwe

Note

1. Greece does not fit this diagnosis. Greece was clearly insolvent before the crisis started, but this was hidden to the outside world by a fraudulent policy of the Greek government of hiding the true nature of the Greek economic situation (see De Grauwe, 2011).

Preface

In Europe, six decades of economic integration among a group of nations contributed to the continent's longest period of peace. Economic progress enhanced peoples' well-being, and the European Union (EU) was – and still is – one of the most prosperous areas in the world. In 2004, the long process of enlargement momentously extended to many Central and Eastern European countries, that for several decades before the fall of the Berlin Wall (1989) had been subject to a centrally planned economic system. The deepening process took a crucial step forward in 1999 with the creation of the Economic and Monetary Union (EMU), which now involves 19 countries adopting a common currency (Eurozone).

However, the last decade was dominated by a dramatic 'double crisis' in the Eurozone, aggravated by inadequacies in the EU's policies and institutions. In particular, mainly due to deficiencies in the design of an adequate multilevel governance, the 'too little too late' approach in European policies contributed to a deep recession followed by stagnation and deflation. The economic crises also caused severe social crises: several Eurozone countries are still characterised by unacceptably high levels of unemployment, especially among young people. In addition, EU institutions showed an inadequate capacity to address new issues like the adoption of safety nets and appropriate adjustment policies to offset the negative impact of globalisation and liberalisations (on certain regions and segments of the population). More recently, failures in the management of immigration flows and in the implementation of a common security system with respect to terrorist risks have become apparent. As a consequence, a growing part of the population of the EU has joined populist or nationalist movements characterised by 'no-Europe' or 'no-Euro' stances. The 'Brexit' process, which began with the result of the June 2016 referendum in the UK, could be a first step towards the EU's dramatic disintegration; or it could conversely be an opportunity to redesign the functioning and policies of the EU's institutions, and, especially, to move the Eurozone towards a truly sustainable path.

In this regard, it should be recalled that 5 years ago the Euro was close to collapse as a consequence of the turmoil generated by the sovereign debt crisis. Then, thanks to more active interventions by the European Central Bank (ECB) (including effective statements by President Draghi), the Euro's crisis seems to have been resolved. However, the sovereign debt crisis, together with the impact of the previous Great Recession, caused widespread stagnation, deflation, job destruction and high unemployment in several countries. In our view, this highly unsatisfactory macroeconomic performance was favoured by the uncertain, delayed, and inadequate policy responses of the EU institutions and individual governments.

As regards the content of this book, we acknowledge that there are already many books and articles on the causes, characteristics, and consequences of the crises in the Eurozone. On the other hand, the number of publications on the process of European economic integration is even greater. Nevertheless, there are still few studies that combine the two perspectives (which are valuable for teaching purposes as well). This book tries to fill this gap.

The first three chapters are devoted to the process of European integration (Chap. 1), the convergence to the monetary union and its building (Chap. 2) and key features of the European monetary policy (Chap. 3). These chapters not only describe the developments in the areas mentioned but also discuss updated empirical evidence (for instance on the weight of the EU's economy in the world) and conduct critical assessment of the weaknesses that have characterised the EMU since the onset. Hence, Chap. 2 contains some empirical investigations on the issue of real economic convergence in the euro area.

Chapter 4 constitutes a bridge between the first and the second part of the book because it not only illustrates the European rules on fiscal policies (Stability and Growth Pact and Fiscal Compact) but also critically discusses the negative impact of the 'austerity' policies followed in the recent period. Chapter 5 provides an account of the 'double crisis' affecting the EU countries, in particular the euro area. Once again discussed is updated empirical evidence (especially for selected countries) regarding key macro-variables; the specific focus is on the collapse of aggregate demand and on the fact that some peripheral countries of the Eurozone are still far from resuming their pre-crisis performances – especially considering output and (un)employment rates. Chapter 6 conducts thorough discussion of the economic policies adopted after the crises (including the 'save-State' funds), which in general have been delayed or insufficient. Only the monetary policy has progressively become more accommodative: the new unconventional measures have been adequate to preserve, so far, the Euro, but not to end the stagnation and counteract the deflation.

The concluding chapter (Chap. 7) deals with two issues: (i) the immediate changes needed in macroeconomic policies and (ii) the enduring reforms necessary to guarantee the long-run survival of the Euro. On the first point, a strong aggregate demand shock is the only effective solution; in fact, structural reforms are important for economic growth only in a long-run perspective. In particular, we propose a major 'Eurozone plan of public investment', much more ambitious than the unsatisfactory Juncker plan. As to the second point, the reforms of EU governance suggested – to be adopted as soon as possible, though some of them may require changes in the treaties – should lead to a monetary union effectively completed by an economic union. For example, the Eurozone should have a specific budget (with adequate resources); a Eurozone Finance Minister, or a European Fiscal Institute, should be created. Eurobonds (both project and stability bonds) should be introduced with a simultaneous reduction of national public debts. A European unemployment insurance system and other stabilisation functions should be partly centralised at the Eurozone level. In general, the principle of risk reduction should be accompanied by risk-sharing mechanisms. The reforms should be much more ambitious, in both content and timing, than those foreseen by the recent 'Five Presidents' Report. Finally, in compliance with the Subsidiarity Principle, an appropriate transfer of political decision-making power at the Eurozone level should be accompanied by an improvement of democratic control and participation, also in order to favour better attunement between European citizens and politicians.

We are aware that, today, the political conditions for adoption of all the mentioned reforms seem to be absent, mainly due to a lack of trust among member countries. However, far-sighted policymakers should convince citizens that it is only by enacting these reforms that the survival of the Euro – and perhaps the EU as a whole – can be assured, while at the same time achieving satisfactory economic performances and enduring social progress. As mentioned above, the 'Brexit' could paradoxically favour a more rapid move towards a complete and genuine Economic and Monetary Union (EMU). More generally, although a 'federal union' is unrealistic at the moment, it should be the ultimate goal, as dreamed by the 'founding fathers' of the European Community. Otherwise, a fragmented Europe will vanish in a globalised world – and this would be a grievous shame borne by future generations.

Brescia and Perugia — Enrico Marelli and Marcello Signorelli

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