

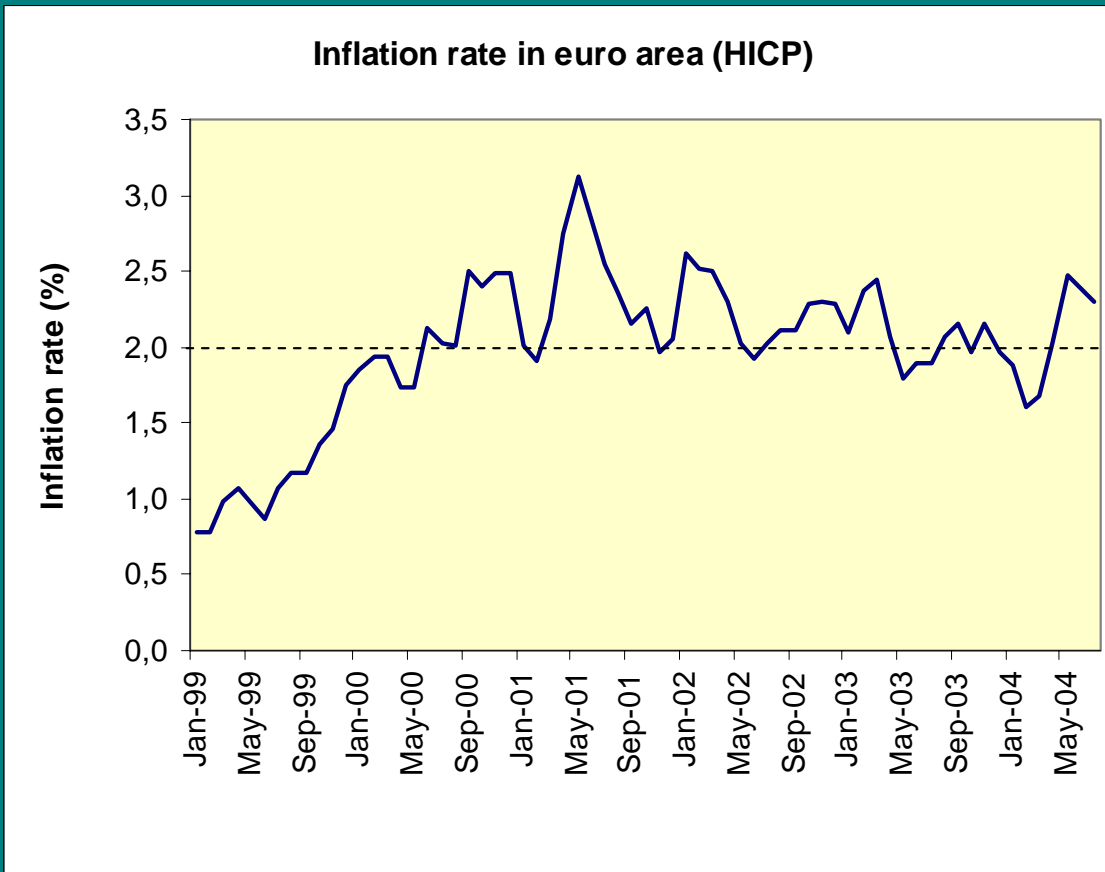
# Flaws in the design of the Eurozone

Paul De Grauwe

- The creation of the euro was a major historical event in the process of European unification
- The fact that it happened can be called one of the major positive surprises in recent European history
- Few persons just 15 years ago thought this would be possible in their lifetimes

- There have been other surprises both positive and negative since the start of the eurozone in 1999
- Let's look at the positive surprises

# Low inflation in eurozone



ECB has been very successful in maintaining inflation close to 2%

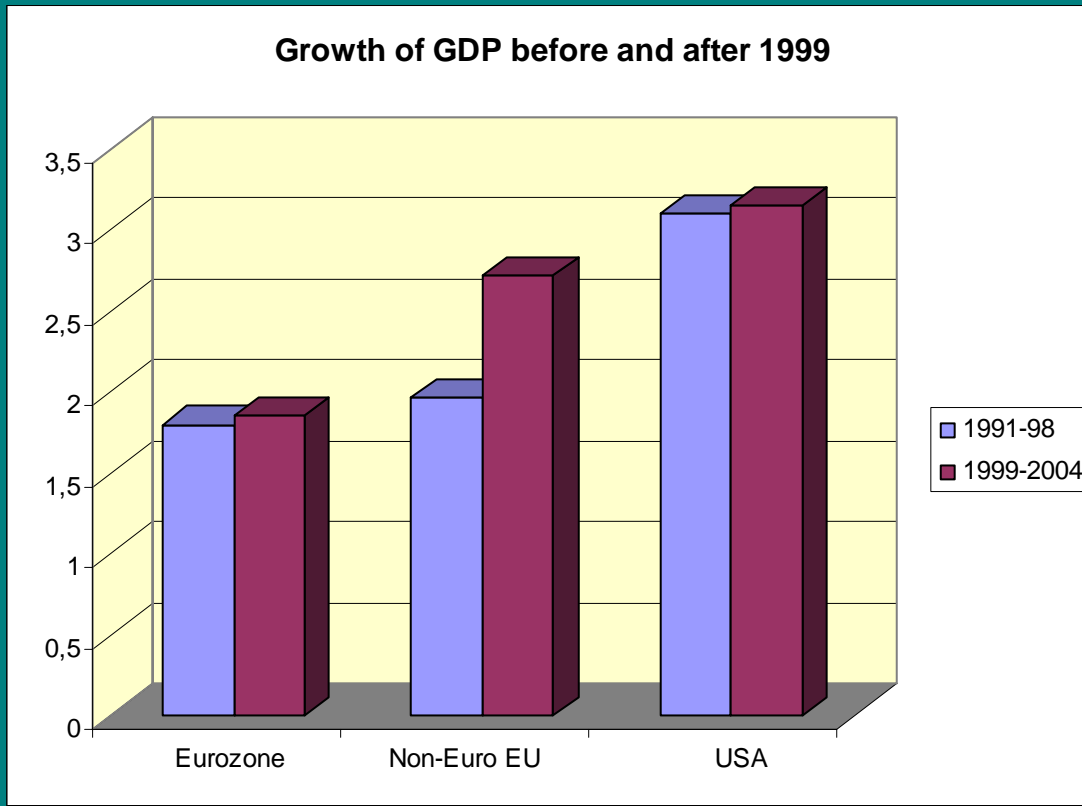
As a result, inflationary expectations are now firmly anchored around 2%

This has made it possible for the ECB to build up a strong reputation for price stability

# Spectacular progress in financial integration

- Money and bond markets are now fully integrated
- Home bias in investors' portfolios is disappearing
- Financial market integration has increased the size of the capital markets in the Eurozone leading to a decline in the cost of capital.

# The less happy surprises: low growth performance



Expectations that euro would boost growth in Europe were strong

Up to now growth performance in eurozone has been disappointing: euro has not been instrument boosting growth

Contrast with EU-member countries which decided to stay outside the eurozone is strong and quite spectacular.

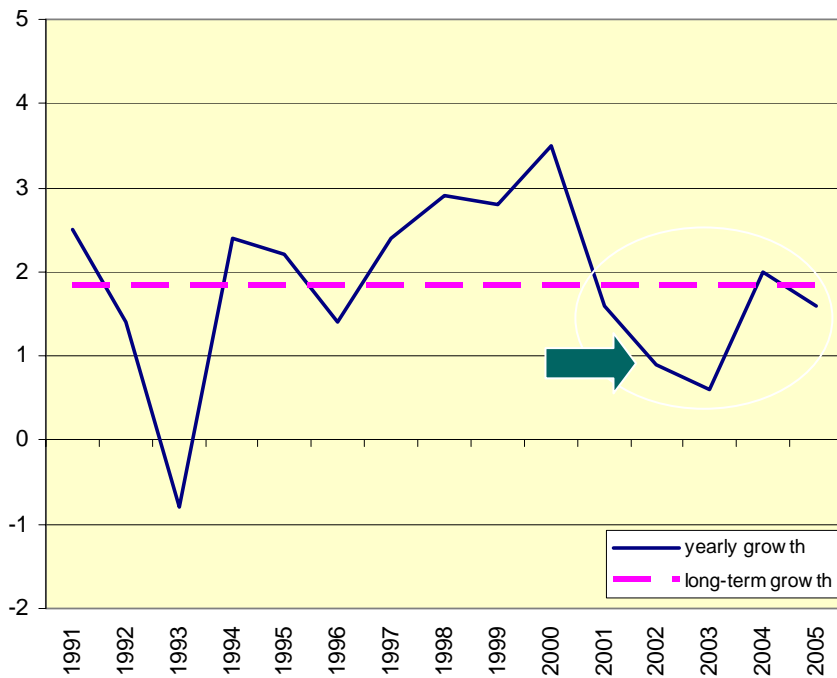
# The bottom line

- Euro is a great financial and monetary success
- It has become popular in financial markets and in banking circles
- This success does not seem to have been translated in the “real” part of the economy, i.e. in economic growth and employment
- As a result, for many people concerned about their economic future the euro is not associated with a success story.

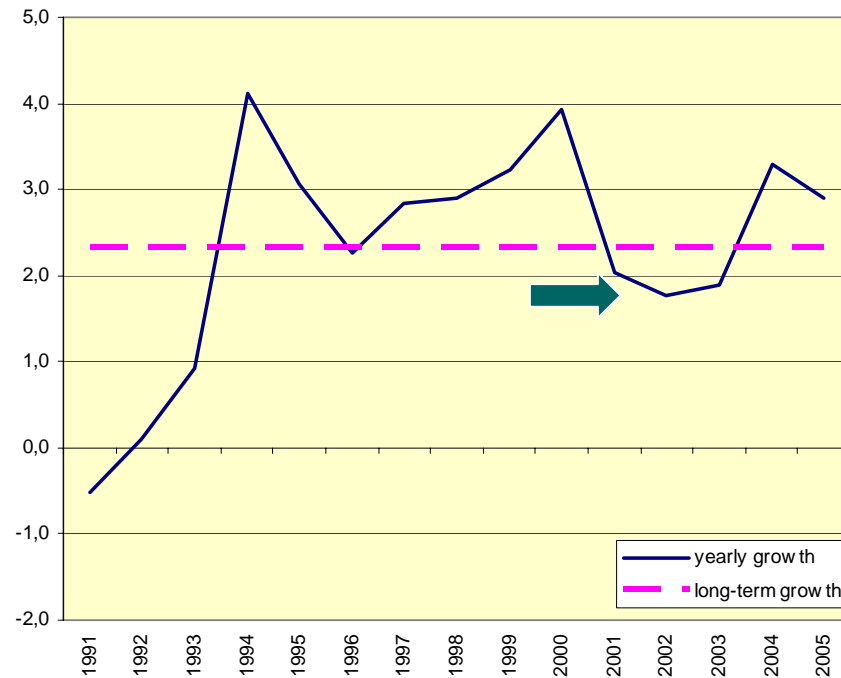
# Where does the contrast between financial success and lack of economic success come from?

- I focus on the growth performance
- Is the lack of success here due to structural rigidities that have nothing to do with the euro? (This is the story we hear from Frankfurt)
- Or is there a flaw in the macroeconomic management of the eurozone?
- As so often in economics, it's going to be a little bit of both.
- Let's try to disentangle the structural from the cyclical

Yearly growth rate and long-term growth in Eurozone



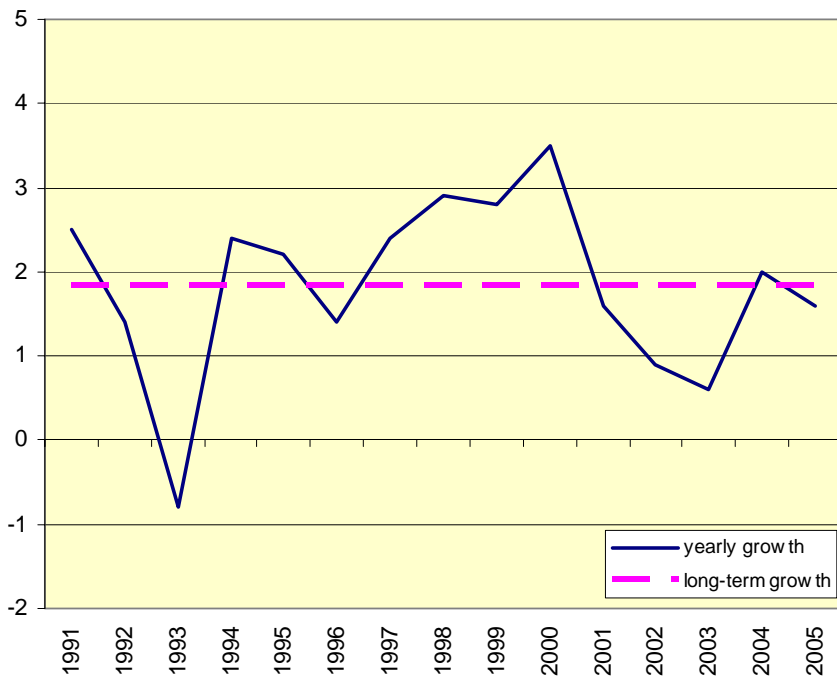
Yearly growth rate and long-term growth in Non-Euro EU



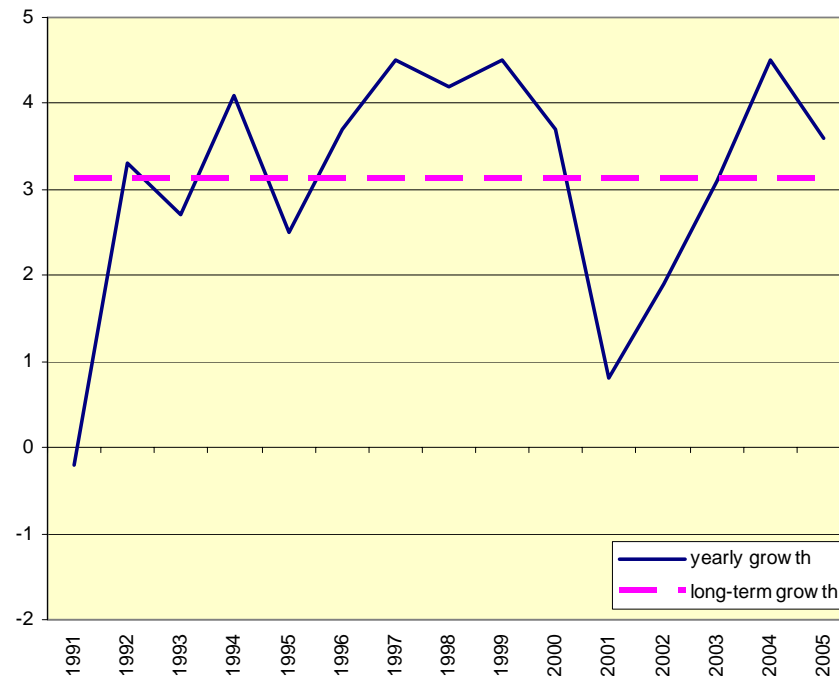
We contrast the eurozone with the non-eurozone EU-15

1. Long-term growth in non-Euro EU is 2.3, in Eurozone 1.8
2. Since start of euro output growth in eurozone has been below long-term growth for longer time than in Non-euro EU.

Yearly growth rate and long-term growth in Eurozone



Yearly growth rate and long-term growth in the US



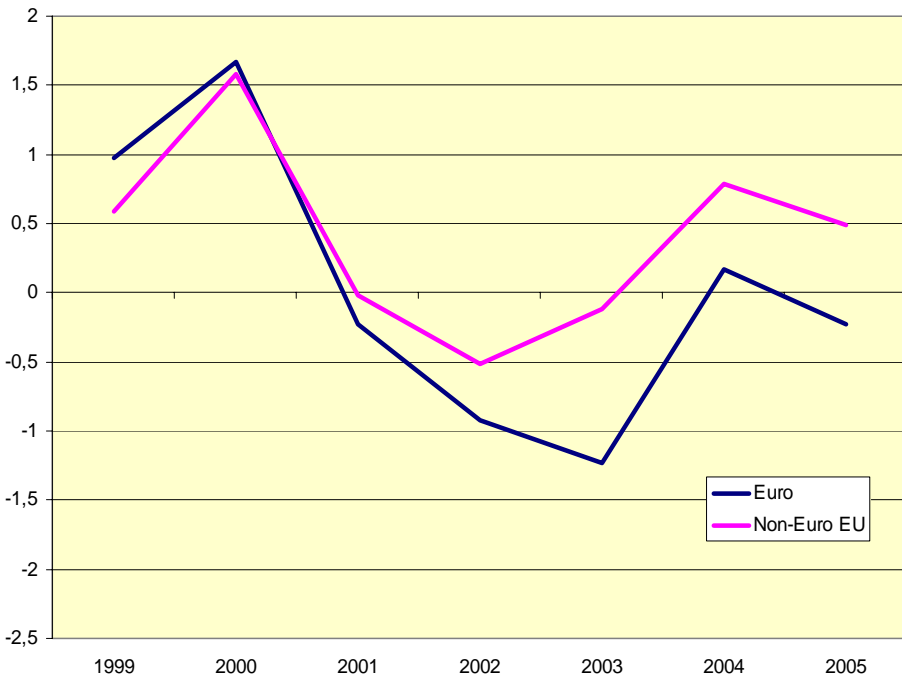
We contrast the eurozone with the US

1. Long-term growth in US is 3.1, in Euro 1.8
2. Since start of euro output growth in eurozone has been below long-term growth for longer time than in US.

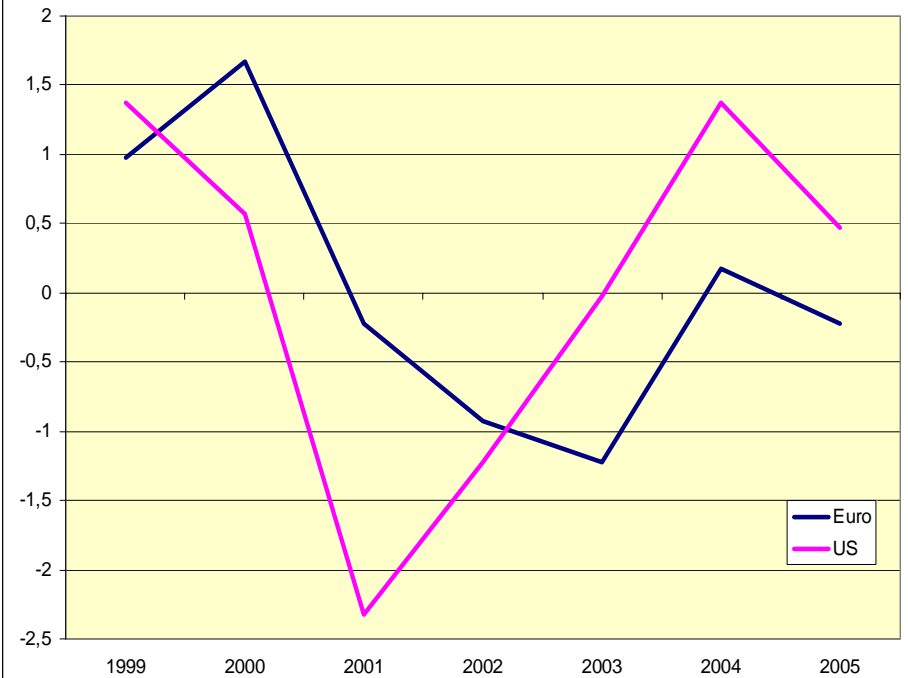
# The structural rigidities story

- It is undeniable that countries in eurozone struggle with structural rigidities
- These lower the long run growth potential of the eurozone
- But this is insufficient explanation for the continued slowdown in the eurozone since 2001
- There is also a problem of stabilization in the eurozone

Difference between current and long-term growth rates in Eurozone and non-Eurozone EU since 1999



Difference between current and long-term growth rates in Eurozone and the US since 1999



Non-Euro EU has been able to pull itself out of the recession more quickly and more strongly

This is not due to differences in long-term growth rate only, since this difference is not more than 0.5%

The difference in growth rates between Euro and non-euro since 2001 is 1.1%

US-recession was more intense, but very short-lived

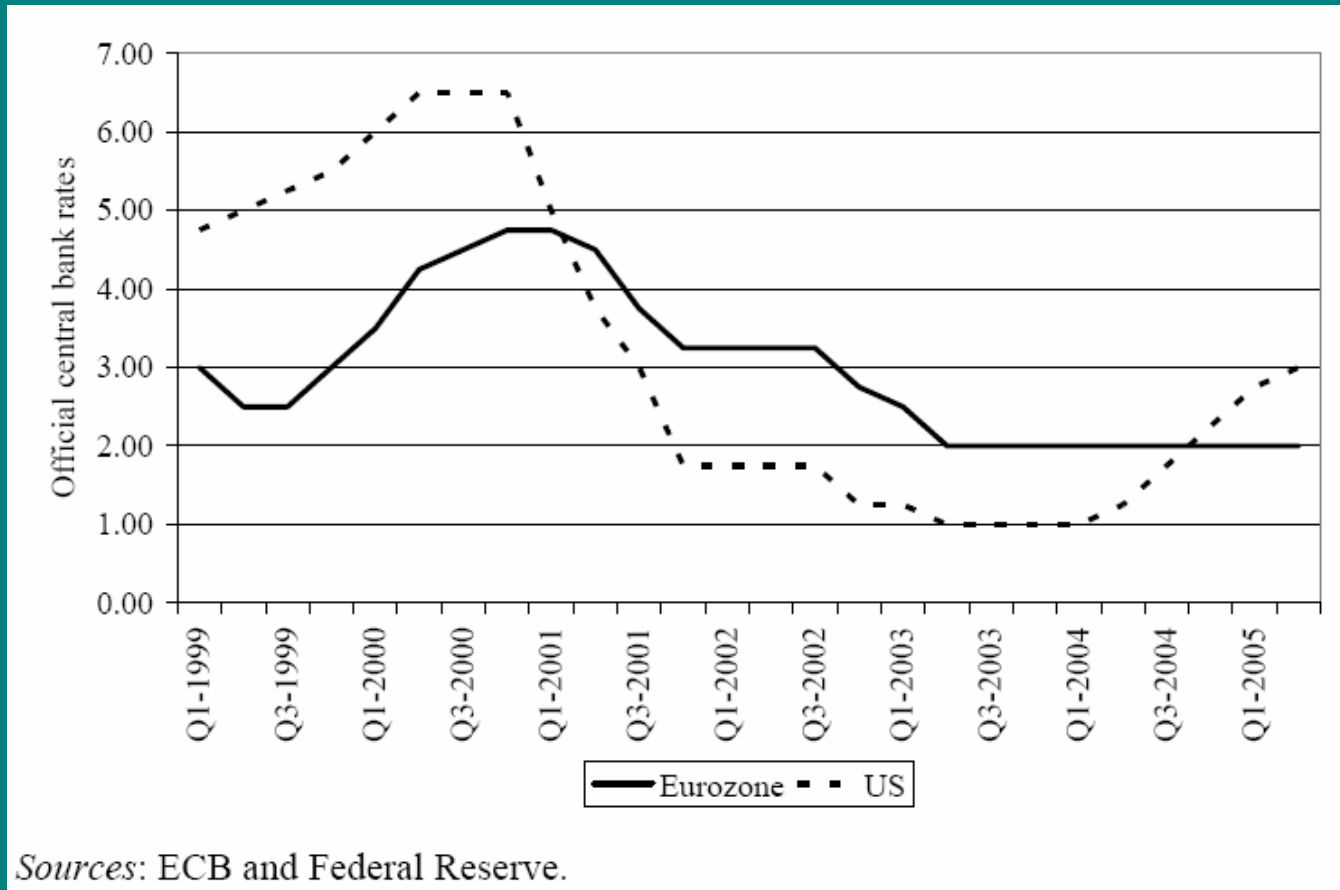
Euro-recession was less intense but protracted

Again these differences cannot be explained only by structural factors.

# Thus, there is more than the structural rigidities story

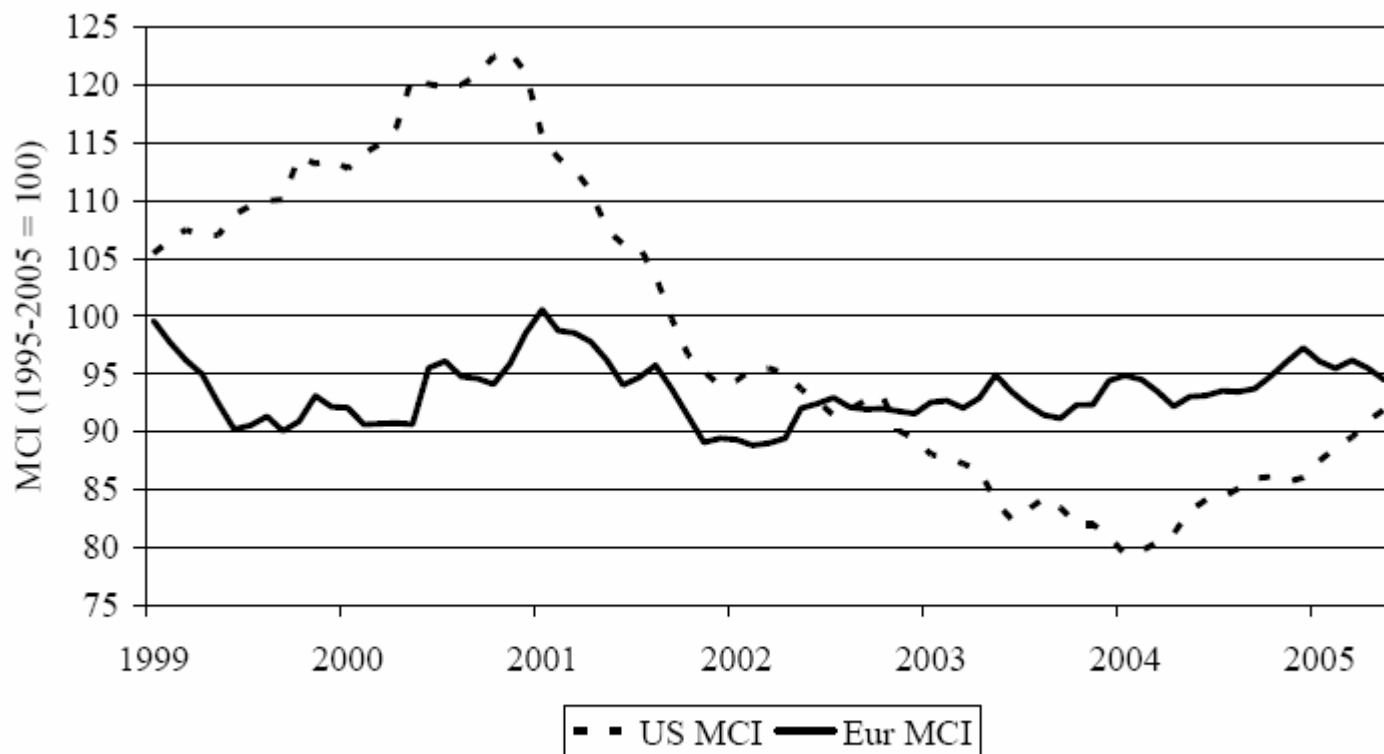
- Too many economists keep repeating the Frankfurt story that it's all structural
- There is also a large cyclical component
- The flaws in macroeconomic management are visible
  - in the monetary field
  - and in the field of fiscal policies

# The contrast between the ECB and the FED



An aggressive series of cuts in the US interest rate in 2001  
Slow and less intense interest rate cuts in the Eurozone  
In general greater activism of the FED and timidity of ECB

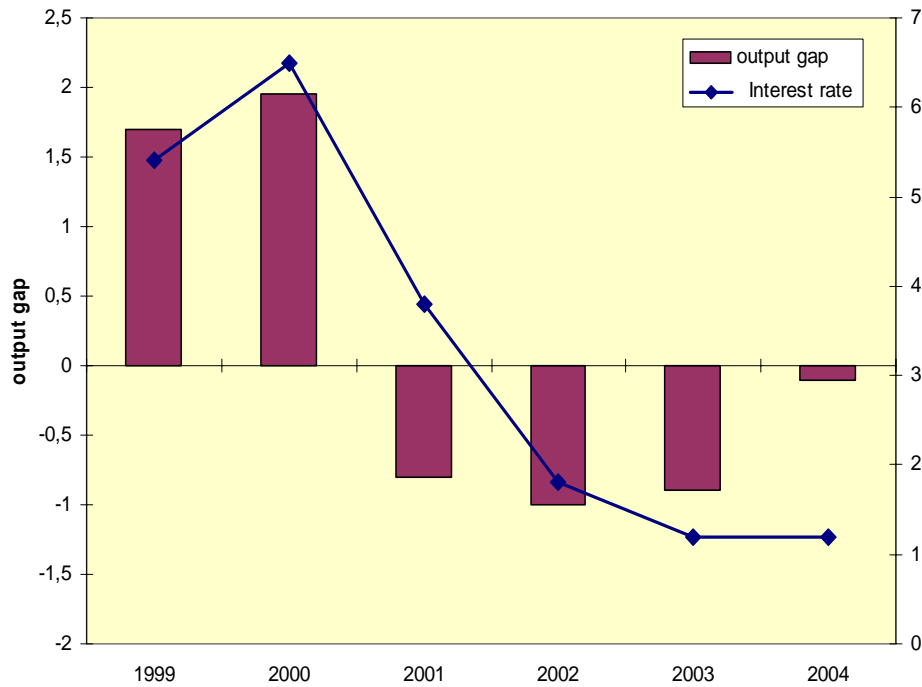
# Contrast is even stronger when comparing MCIs



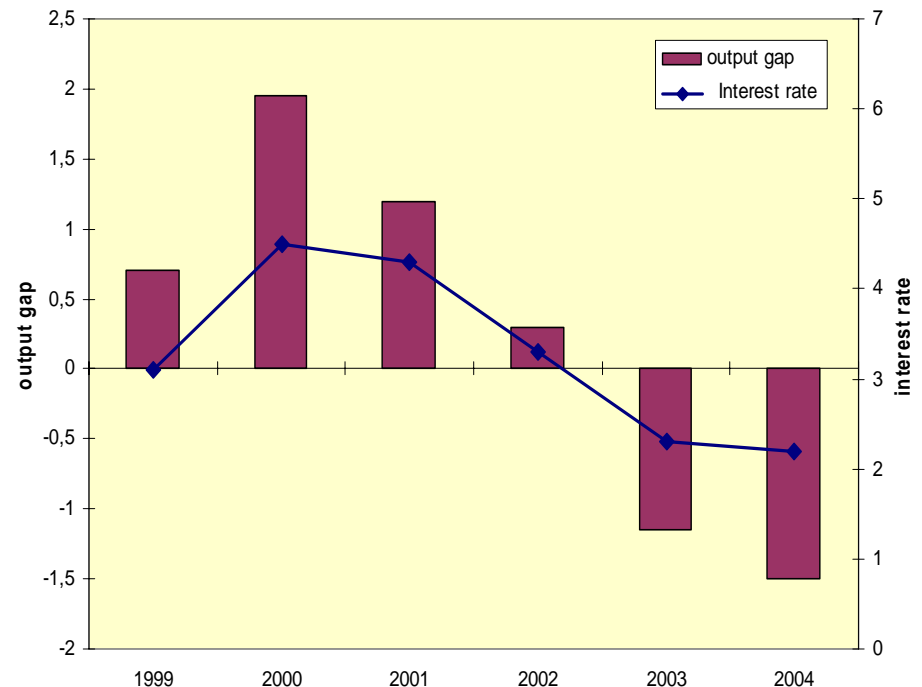
Source: Deutsche Bank.

MCI= monetary conditions indicator= average of interest rate and exchange rate change  
In Eurozone: ECB's interest rate cuts of 2001-03 were fully compensated by appreciation of the euro

Short-term interest rate and output gap in the US (1999-2004)



Short-term interest rate and output gap in the Eurozone (1999-2004)



US Fed went further in its interest rate cuts than the ECB  
Thereby contributing to a speedy recovery.

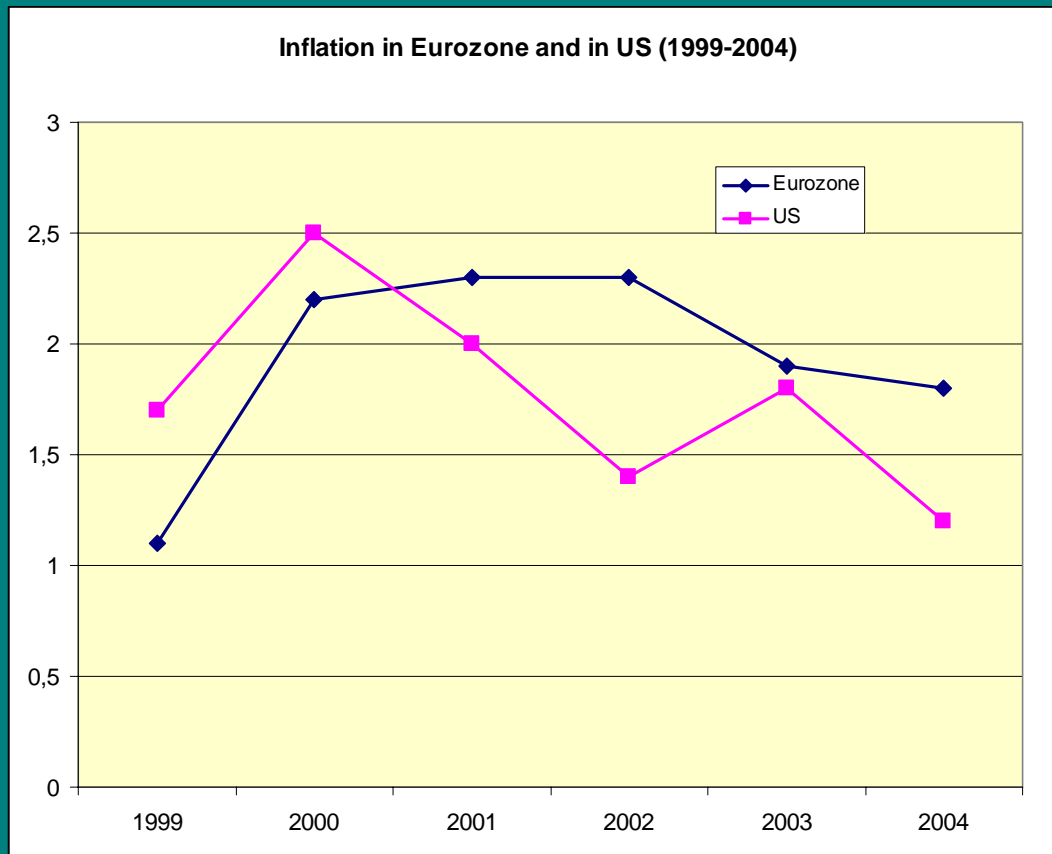
# Conclusion: ECB has been more cautious than FED in fighting the economic slowdown

- Why?
  - Different mandate
  - Need to establish credibility of toughness on inflation
  - Different underlying theory (monetarist in Europe; Keynesian in the US)
  - Lots of asymmetries in monetary union paralyzing monetary policies

# Different mandate

- Fed's mandate described in the Employment act of 1946 requires the Fed to care about the business cycle
- The ECB's mandate is to maintain price stability. This is the primary objective. Other objectives should not interfere with this primary objective.

# ECB's desire to establish credibility led it to define too tight an inflation target (<2%)



Thus in 2001 and 2002 when the economy slowed down the ECB perceived an inflation rate of 2.3 to be excessively high

This perception, however, was the result of a self-imposed limit of 2%

It traumatized the ECB

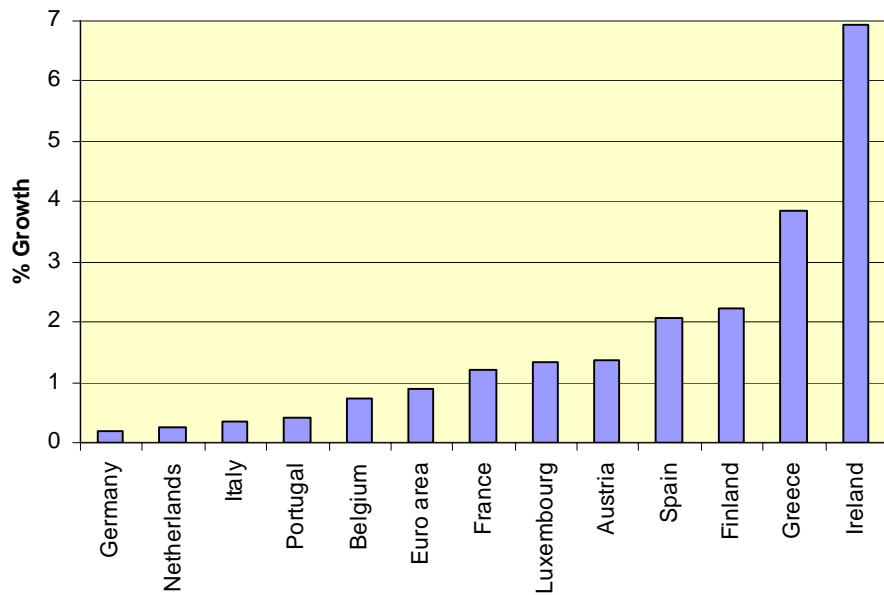
The problem was artificially created by the ECB

# Different paradigms in the US and the Eurozone

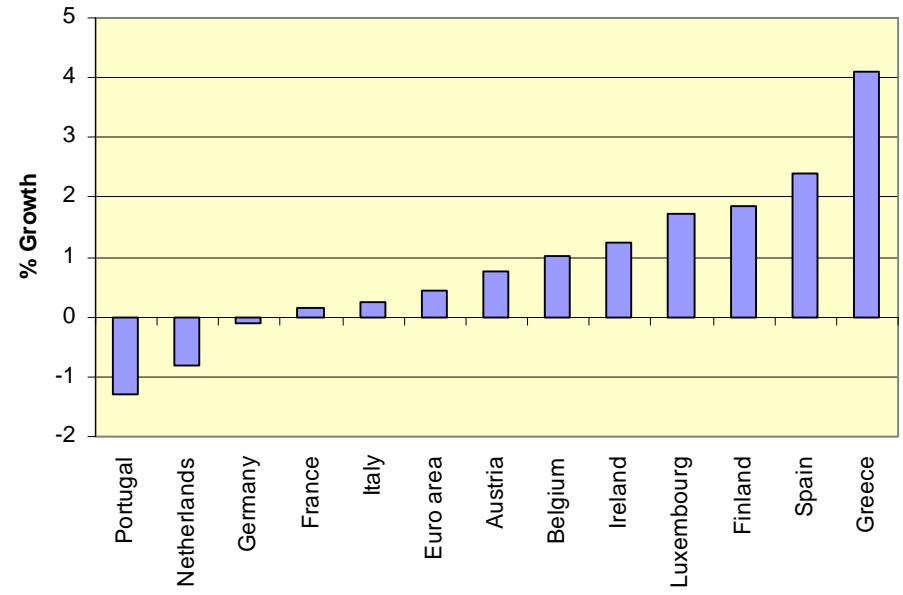
- Surprisingly the Fed has shown to be strongly Keynesian
- While the ECB adheres to strong form of monetarism
- I will come back to some implications of this difference

# Surprisingly strong asymmetries in business cycles paralyze monetary policies

Growth of real GDP in Euroland in 2002 (in %)



Growth of real GDP in Euroland in 2003 (in %)

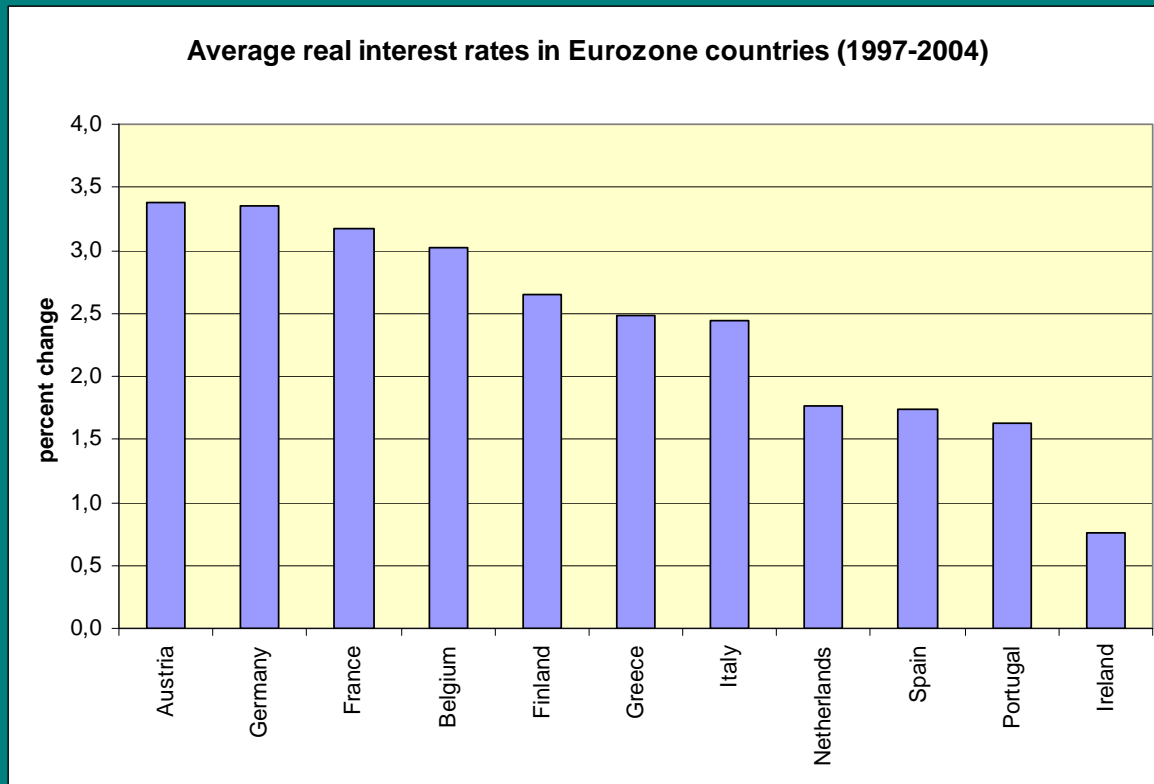


Wide range of experiences made it difficult to react appropriately to the average slowdown in the Eurozone during 2002-03

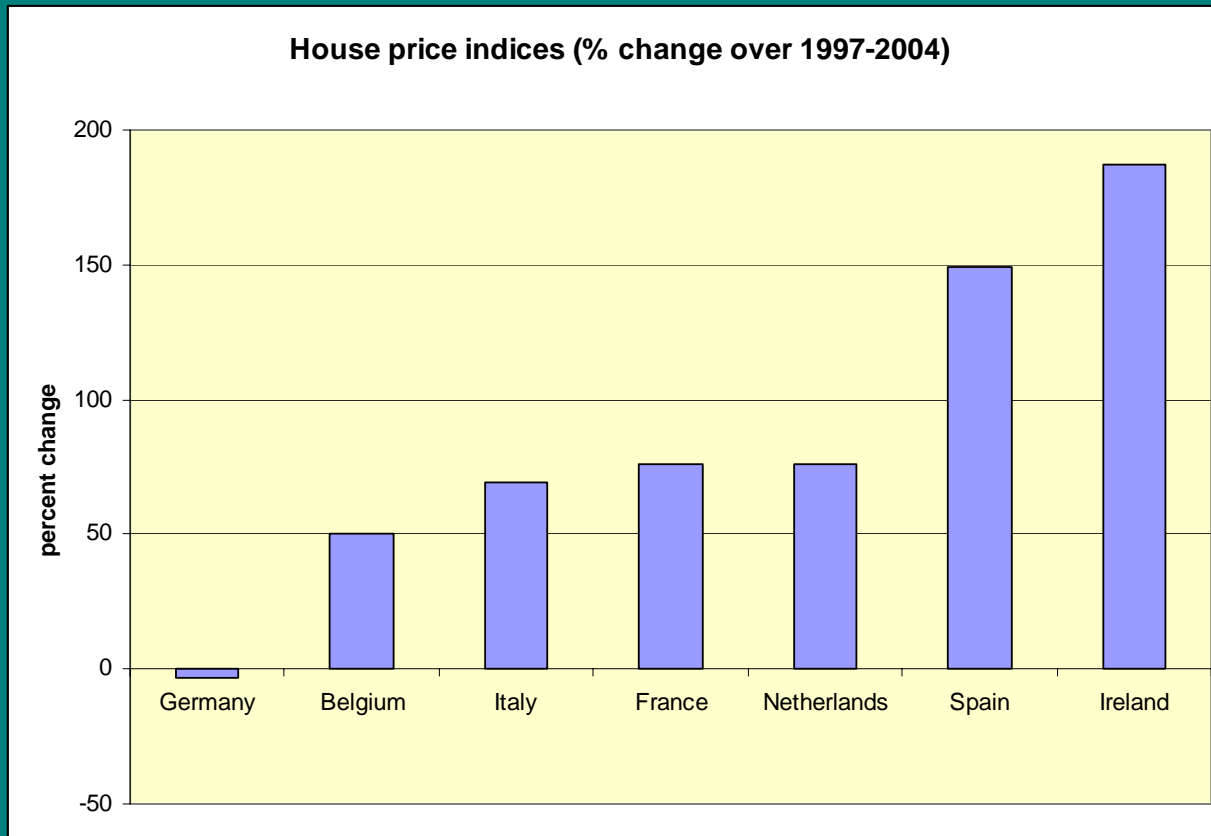
# Other asymmetries complicate monetary policies

- Large inflation differences within Eurozone
- combined with the same nominal interest rate in the Eurozone
- create large differences in real interest rates

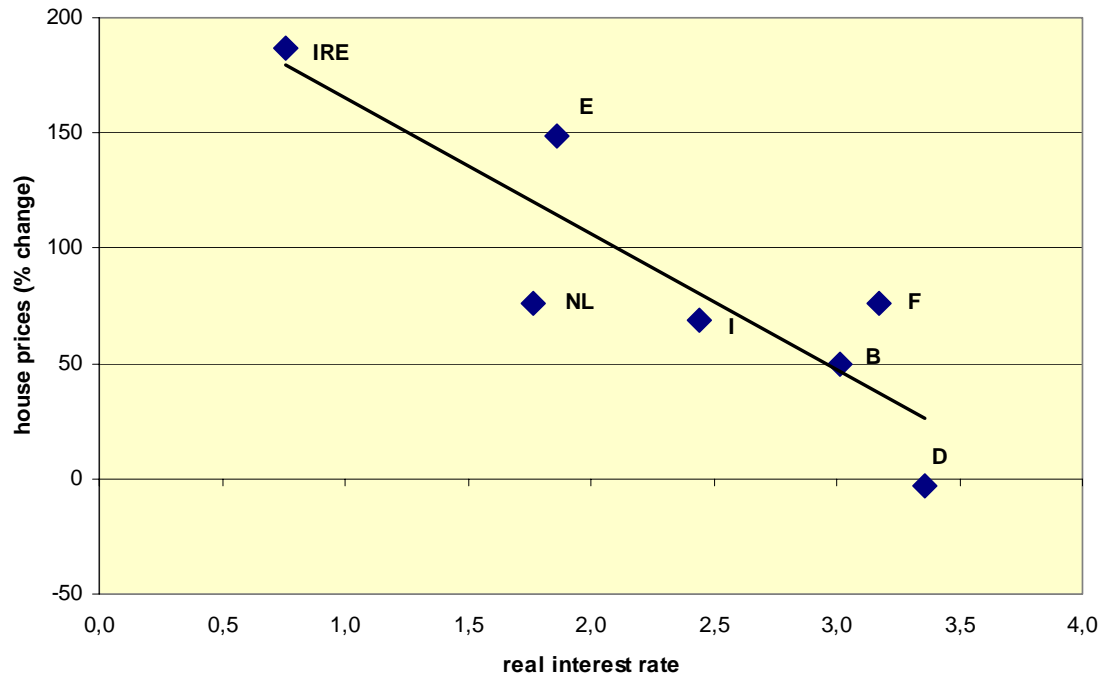
# Large differences in real interest rates in Eurozone



# Create large differences in house price inflation



Real interest rate and house prices (% change)  
1998-2004



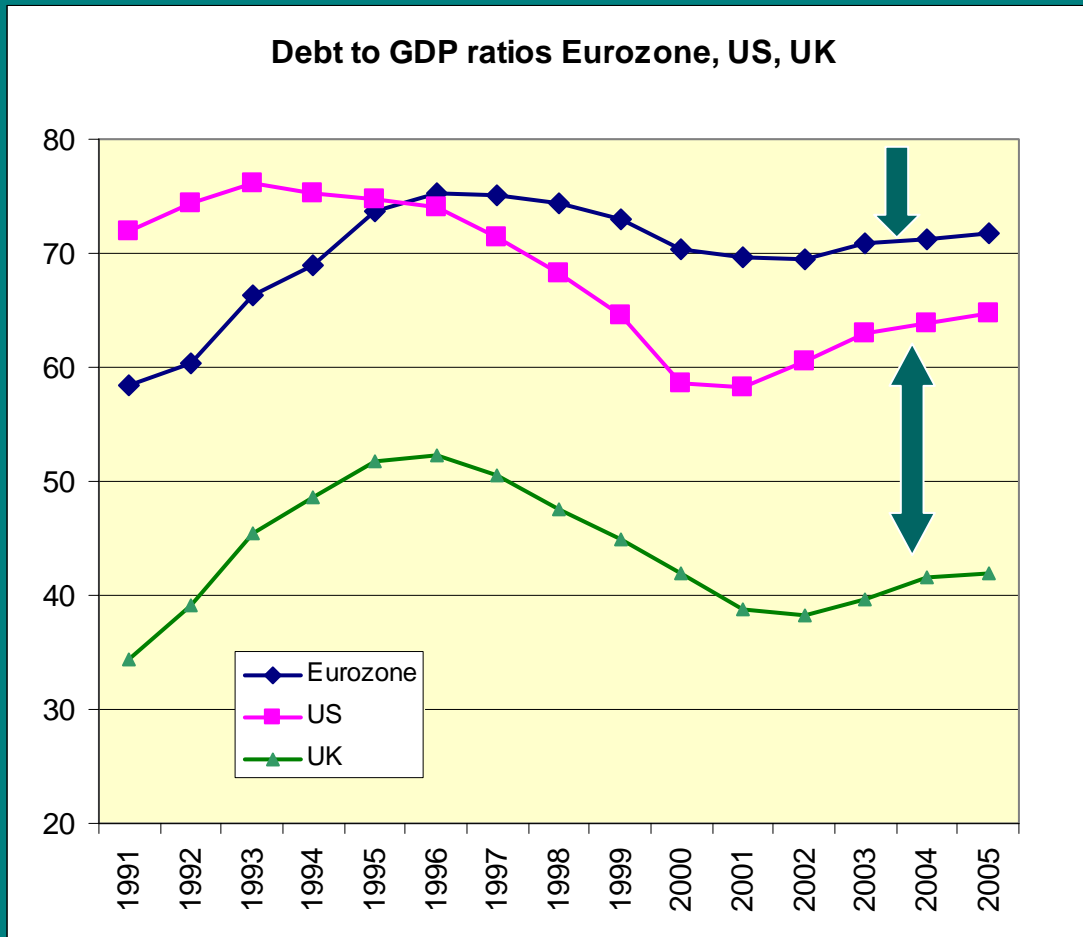
The effect of this endogenous asymmetry is that ECB hesitated to lower interest rate

lest it would exacerbate the housing bubbles in a number of eurozone countries.

Thus, this housing market asymmetry contributed to the policy paralysis during recession.

# What about fiscal policies?

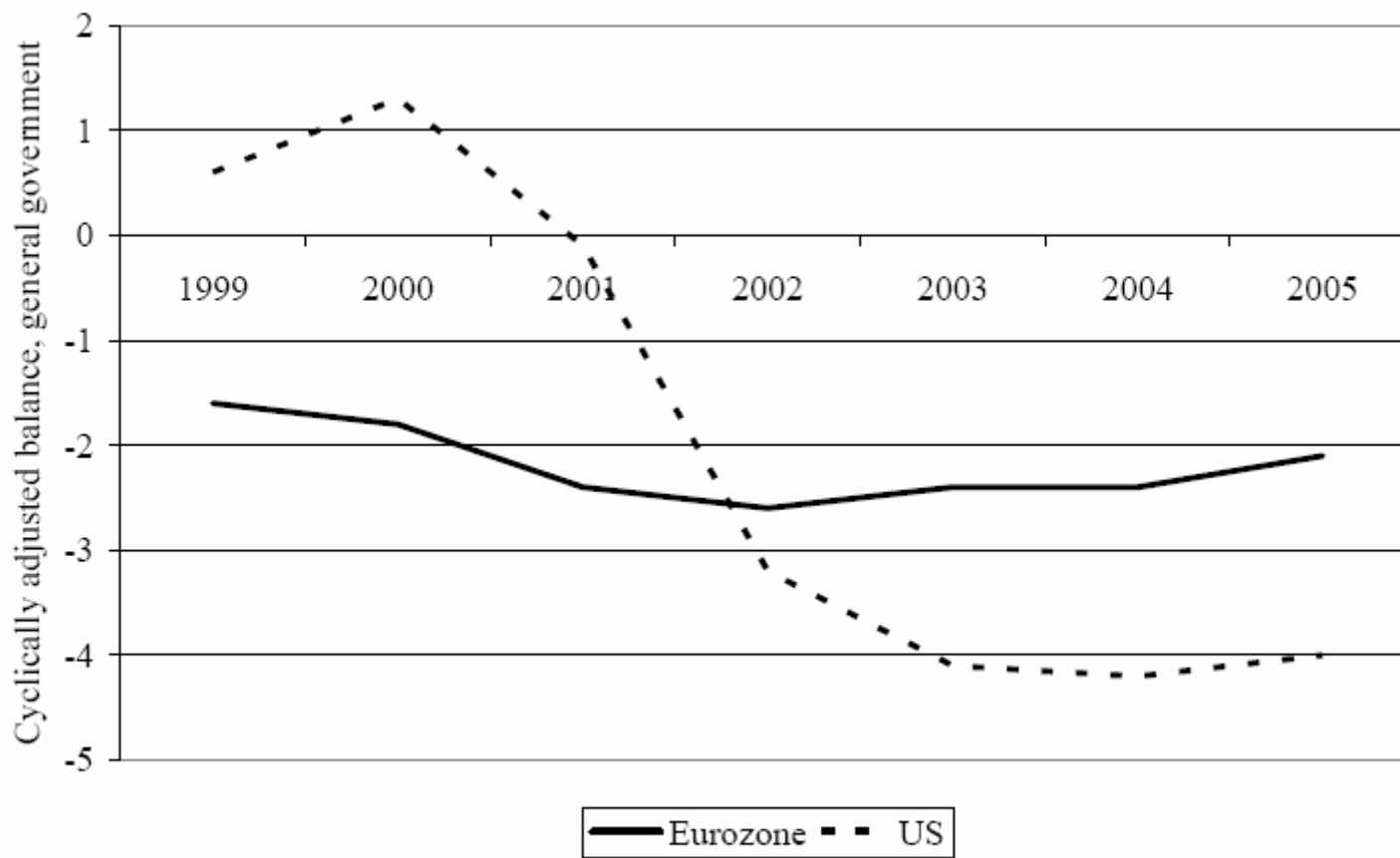
## Similar paralysis



Eurozone countries have kept government debt ratios constant despite economic slowdown

US and non-eurozone countries have been willing to follow stronger Keynesian policies, allowing stronger increases in government debt ratios.

# Cyclically adjusted deficits make contrast even stronger: activism in US-paralysis in Eurozone



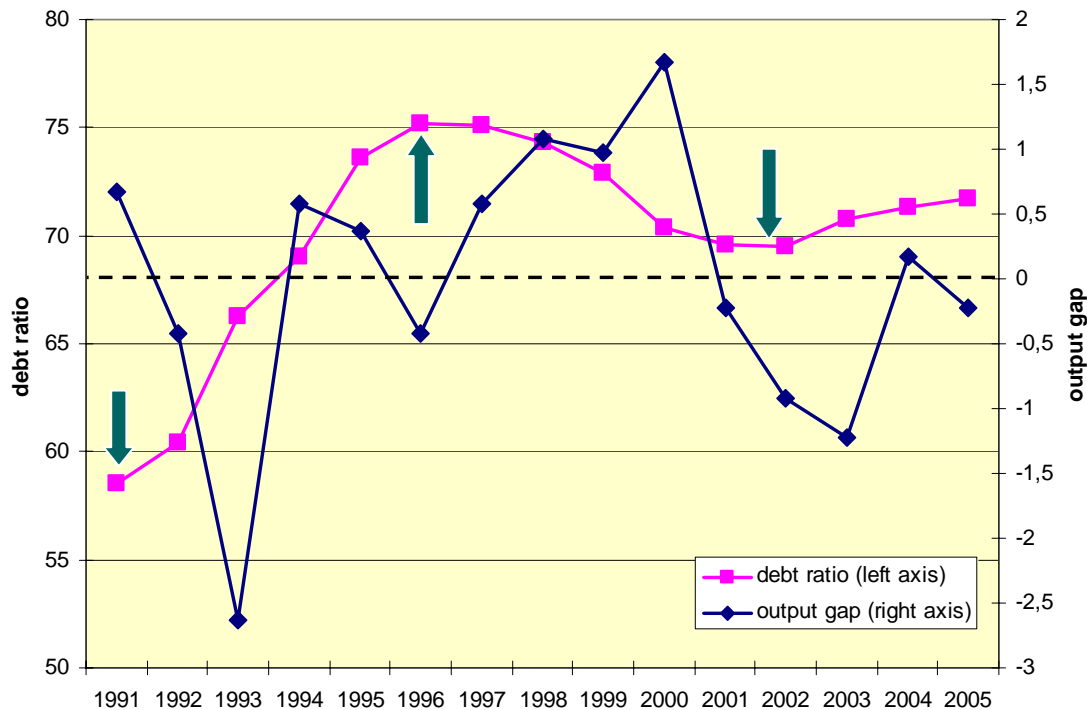
Source: European Commission.

# Why Eurozone countries failed to follow countercyclical budgetary policies

- The legacy of the past
  - High debt levels
  - Failure to reduce debt during boom
- The role of the stability pact
  - Excessive focus on holy numbers (“3”) prevents automatic stabilizers to work
  - Has led some countries to apply restrictive budgetary policies in the face of a recession

# The legacy of the past

Debt to GDP ratio and output gap in Eurozone



During recession of 1992-93 there was very strong increase of debt

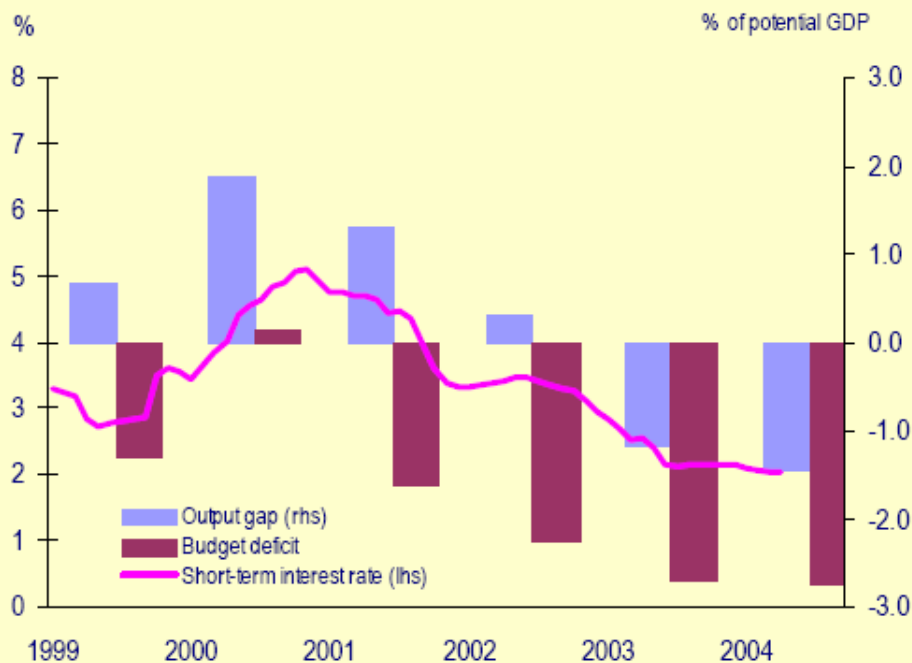
This contributed to making the recession short-lived

However during boom of 1996-2000 debt decumulation was very weak

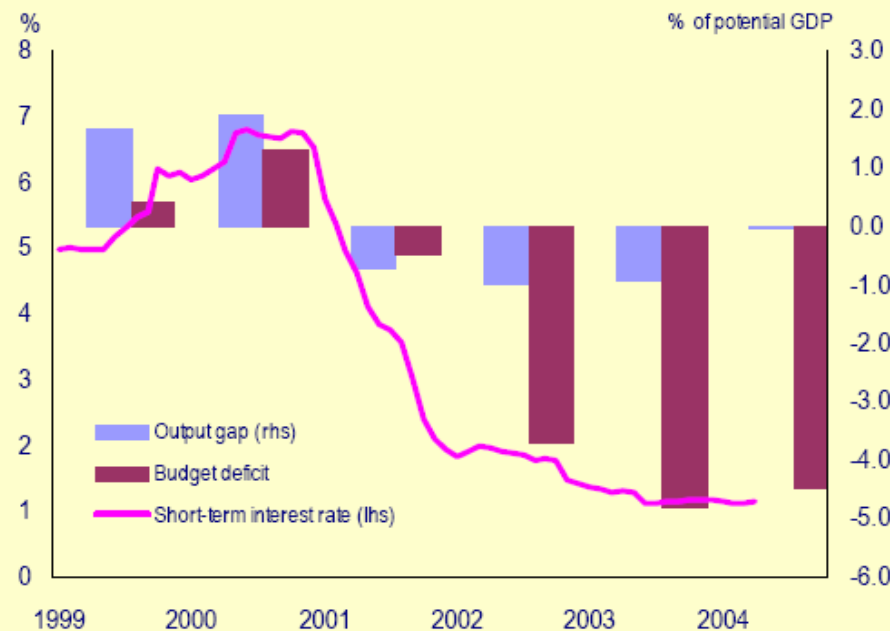
As a result, during recession of 2001-05 there was little room to expand the debt.

# Summary of the contrast between eurozone and US

Graph I.13: Euro area macroeconomic policies



Graph I.12: US macroeconomic policies



Has US gone too far in using Keynesian monetary and fiscal policies?

Future will tell

Eurozone certainly could have done a little more

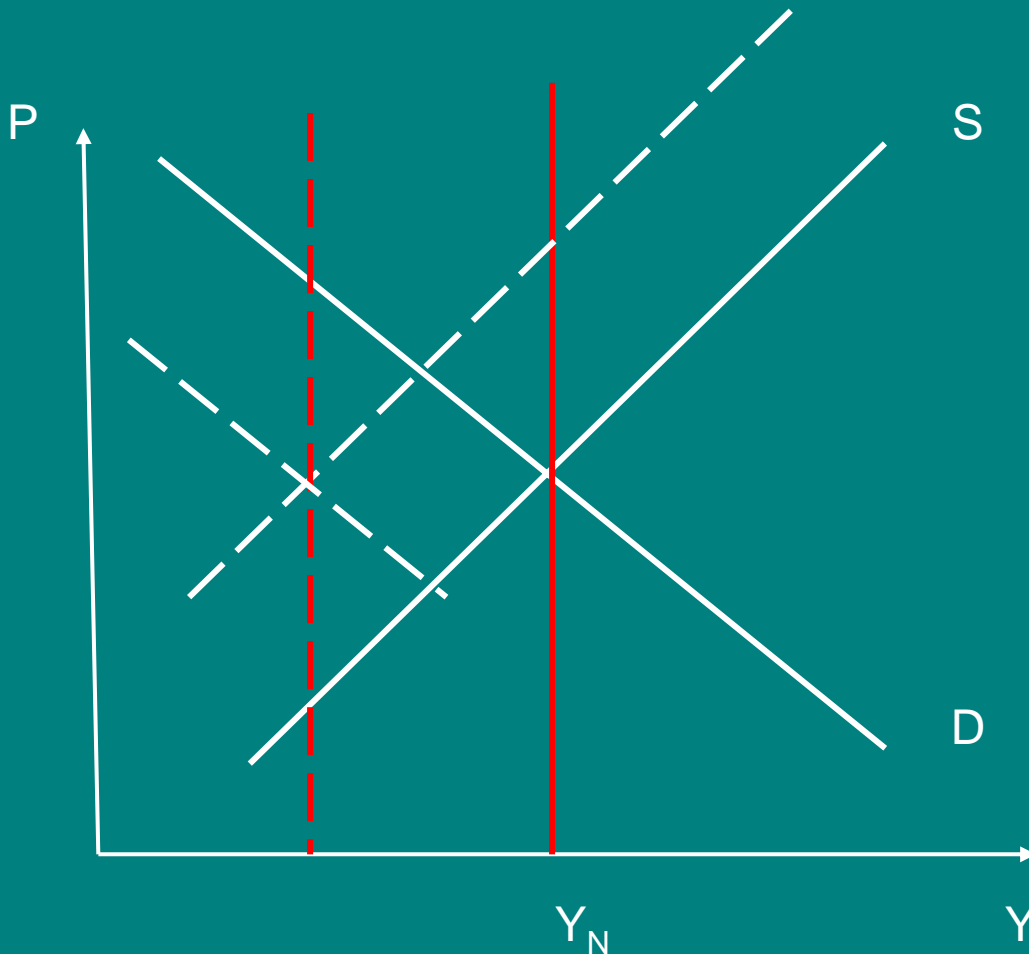
# Two paradigms to explain differences between US and Eurozone

- Brussels-Frankfurt consensus:
  - Structural rigidities lead to lower growth
  - Monetary and fiscal policies cannot do anything about this
  - Except make things worse
  - By leading to more inflation and debt explosion
  - Structural reforms are necessary

- Alternative view

- Economies are subjected to “animal spirits” of optimism and pessimism
- Eurozone does not have instruments to stabilize economy during recession
- Investment declines, leading to decline in capital per worker
- This leads to decline in productivity
- All this leads to mounting budgetary deficits, and unsustainable debt

# Frankfurt-Brussels consensus

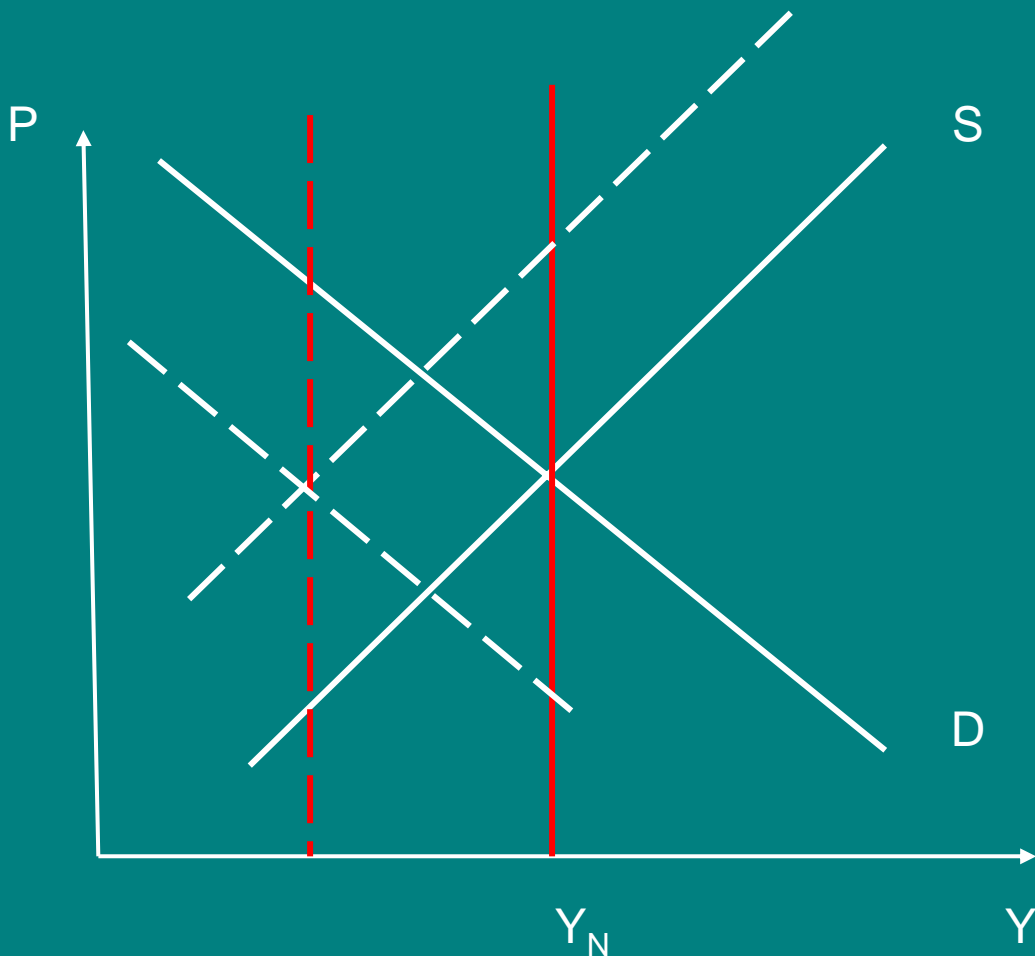


A negative supply shock

leads to pessimism and low demand

Authorities can only help by structural reforms to beef up supply

# Alternative view: same result but different dynamics



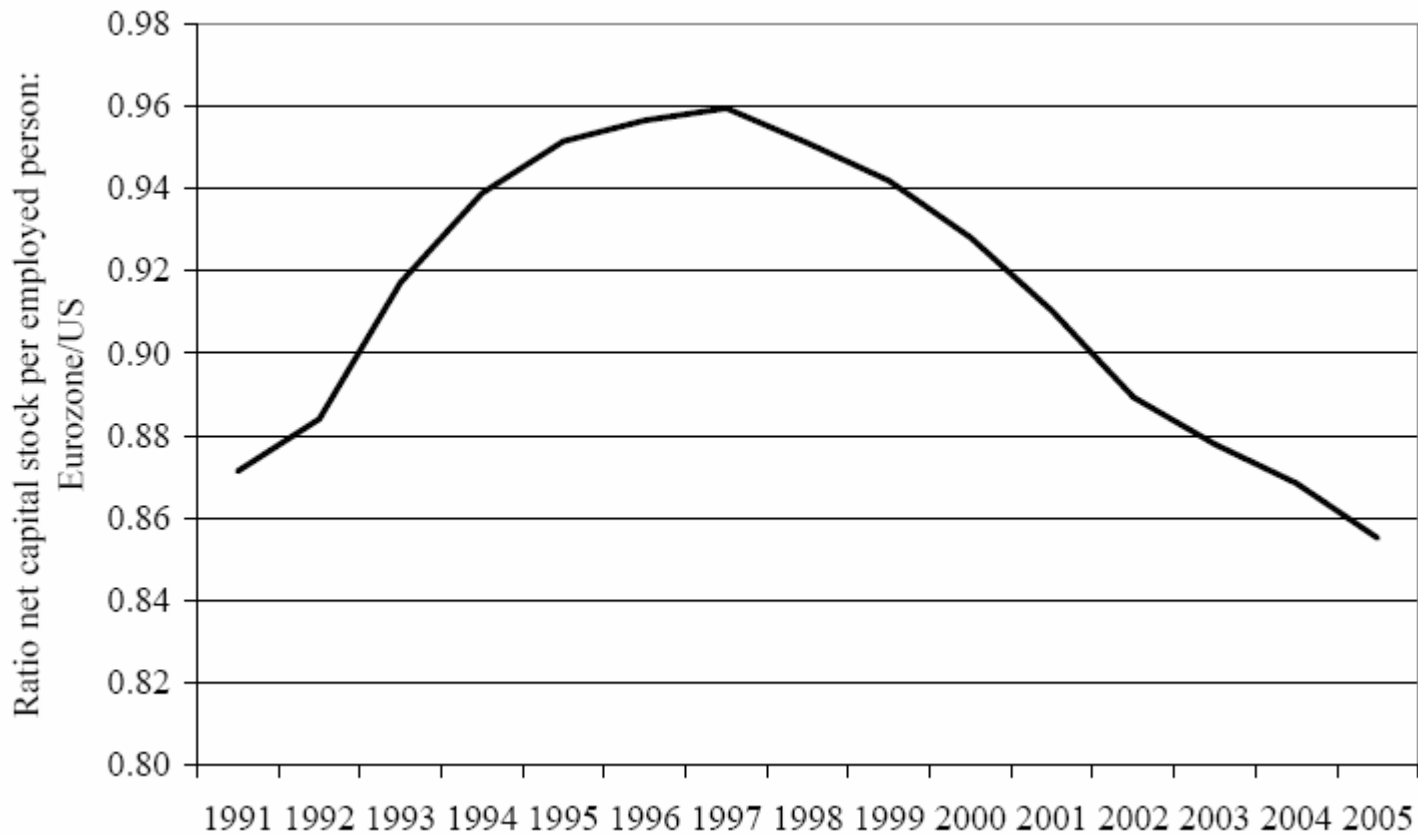
A negative demand shock starts it all

Authorities do not react

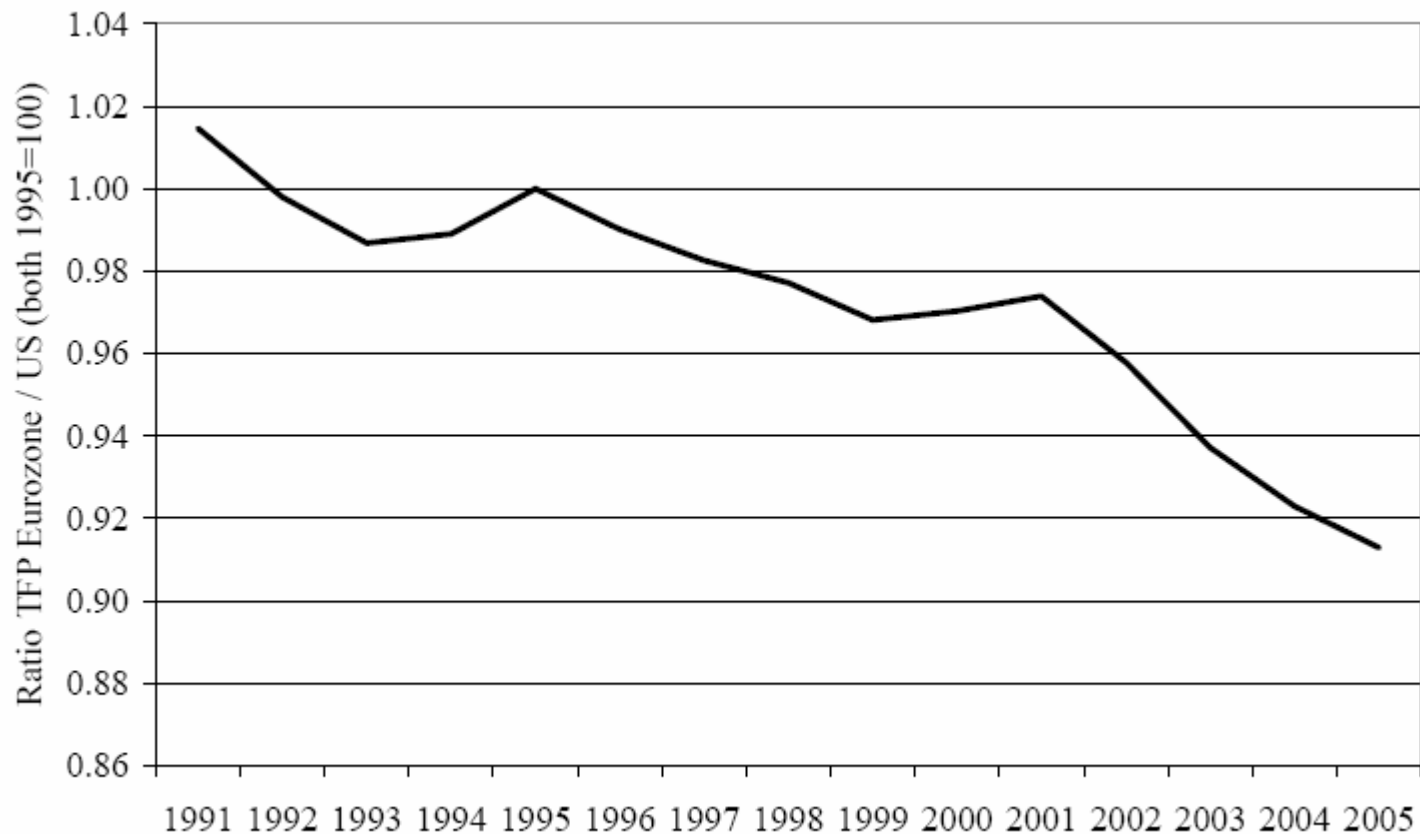
Investment declines leading to decline in productivity

Negative supply shock follows

# The facts: Declining investment in Eurozone relative to US



# The facts: deceleration of productivity growth in Eurozone



- Unresolved issue: which way goes the causality?
- In Frankfurt-Brussels consensus the root cause is structural rigidity that leads to low productivity growth and thus to low investment
- In alternative view the failure to stabilize during a recession reduces investment which in turn leads to low productivity.

- In my view the slowdown since 2001 has a large demand component
- The Eurozone is particularly ill equipped to deal with such demand shocks
- Both at the aggregate Eurozone level
- And at the level of individual member states
- This creates a potential for intense conflicts between the member states.

# Prospects for the future of the eurozone

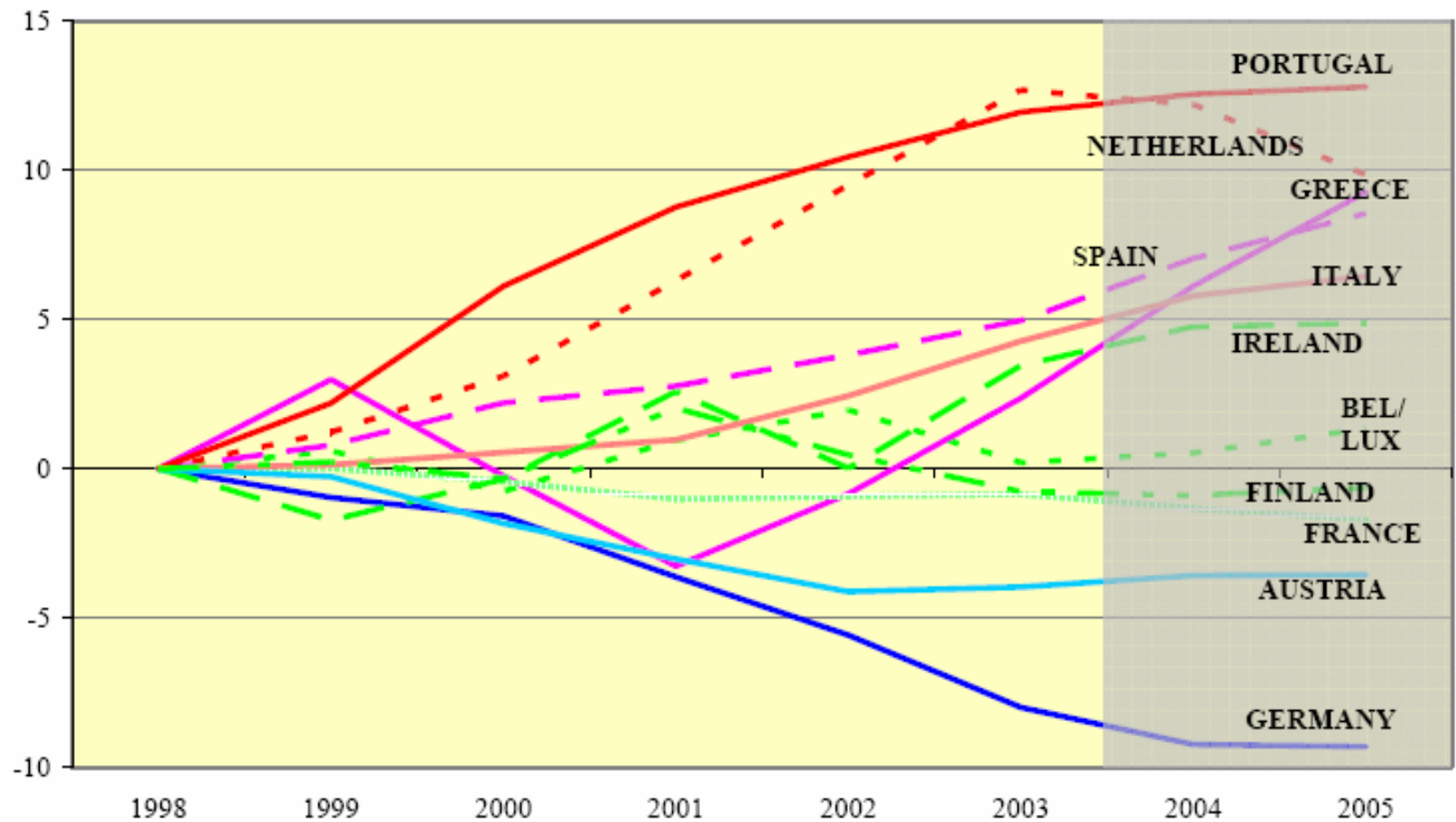
- The past is always easier to analyze than the future which is clouded in mystery
- Much of what I have to say about the future will be highly speculative

- Present situation is dangerous:
  - The euro has not provided clear benefits for a number of countries
  - In fact it is perceived to have contributed to economic slowdown
- Much of the problem has to do with asymmetric, divergent developments within the Eurozone
- which paralyze the ECB
- and lead to failure to stabilize the Eurozone business cycle

- Some of these divergencies are structural
- Others have a political origine
- i.e. many economic decisions continue to be made at the national level
  - Spending and taxes
  - Social policies (e.g. 35-hour week in France)
  - Wage agreements
  - Housing policies

- These create large asymmetric shocks
- and contribute to divergencies
- This is unlikely to stop
- In fact these divergencies accumulate over time
- Example: relative competitiveness

Graph II.17: Intra-euro area real effective exchange rates 1998-2005  
 (ULC Total economy, Index 1998=100)



Source: European Commission

- Such divergencies are bound to lead to crises
- As some countries find no way to correct for their losses of competitiveness
- Temptation to leave the union will mount
- This temptation will be all the stronger as the monetary union is not embedded in a political union

# Can monetary union survive without political union?

Political union is necessary to embed a monetary union and to make it sustainable in the long run.

I see three reasons for this

1. political union makes it possible to organize fiscal transfers that provide some insurance against asymmetric shocks.

This increases the sense of belonging to the union and enhances its social and political base.

Countries will not stay in the club if they are constantly told that when they are in an economic mess they have to get out of the mess on their own without the help of the others

2. political union reduces the risk of asymmetric shocks that have a political origin
  - Spending and taxation policies
  - Wage policies
  - Social policies (e.g. 35-hours in France)are national and are sources of asymmetric shocks

3. Political union also makes it possible to have a fiscal policy at the level of the union that can complement and back up monetary policy.

The absence of a central budget in the Eurozone implies that no budgetary policy aimed at stabilizing the business cycle in the union is available.

As a result, all the pressure is on the ECB who is unwilling/incapable to take up responsibility

Contrast with US is strong

# Prospects for political unification

- Recent no-votes about constitution seem to signal that Europeans do not want to move forward into political union
- It could even be interpreted as signalling a reversal of the existing level of political union as each country returns to its little political cocoon.
- This would endanger the long run sustainability of monetary union in the EU.

- Failure to move towards further political integration puts Eurozone at risk
- When we moved into Eurozone we moved into a beautiful house
- ...which lacked a roof

- Without political integration the Eurozone will be a house without a roof
- which will become increasingly uncomfortable
- Many inhabitants at some point will want to move out of the house.