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The euro-area crisis: what went wrong, what should be changed, what could be changed ?

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Joint Research Seminar WIIW/JVI

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OVERVIEW

1. The crisis of the €: worse coming soon…
2. The essential of the <u>ex-ante EMU</u>: political economy of the Maastricht Treaty conceived as an "asymmetric building" compensated by progressive coordination dispositions and an expected integration dynamics moved by the fears of "one-fits-for-all" dimension
3. The <u>ex-post EMU</u>: how positive results and advantages of the single currency combined to surveillance failures, made policymakers too complacent…
4. Turning perverse the working of € against its own logics in an US$-led course to easy-money
5. The present debates: <u>was Maastricht wrong?</u> No, architecture is OK but has not yet been applied (wrong enforcement method based upon political decisions)
6. Making enforcement credible is vital for € survival

The €-area crisis has just started

1. **The risks were long to appear: the "<u>€ convergence illusion</u>" was so deeply rooted that neither the growing imbalances nor the banking crisis (in spite of nationalistic responses) were disruptive; the global crash of 2008 even reinforced the € financial stability up to the wake-up call of €-Greek bonds in early 2010**
2. **The EU and national officials continue to <u>congratulate themselves</u> on the EMU shelter and their ability to manage the rescue plan and to be able to propose now the "***the most sweeping transformation of economic policy-making in the EU and euro area since the launch of EMU*".
3. **Nevertheless the <u>lack of consensus</u> inside the EU has reached unsuspected and worrying deepness at the moment cyclical divergences announce tough dilemma**

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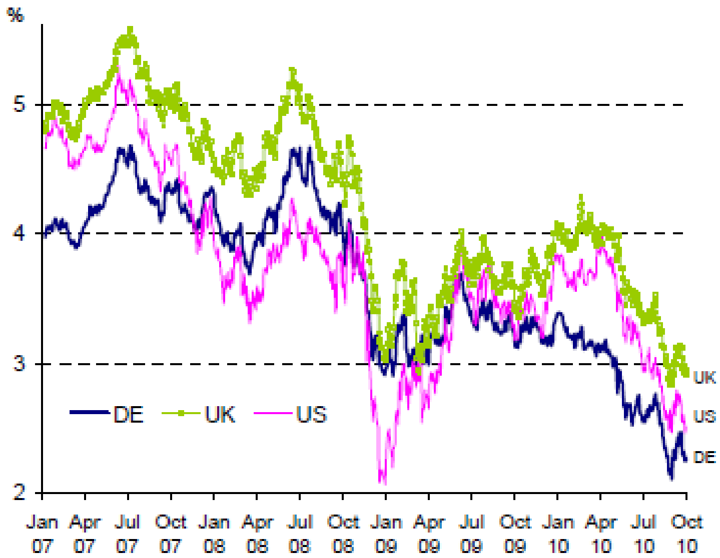
The €-area crisis has just started

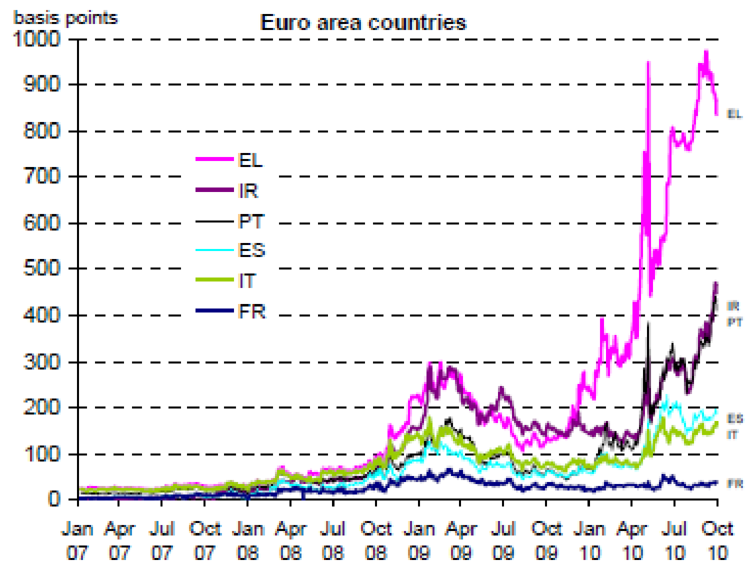
- **Nothing has been solved, but buying time: <u>debt crisis is the lack of growth issue</u> (not just cyclical, Greek debt will explode with the lack of growth, the Irish is worse, Portugal, Spain, Italy will follow…), the banking system weaknesses (<u>stress test</u> are not anymore credible, Banks live from ECB low rates), <u>governance failures</u> (conflicting views on the rise, Commission proposals are more-of-the-same inapplicable sanctions and Pact, Van Rompuy's group is still blocked by divergences)**
- **<u>Vicious circle</u>: weaker recovery => higher uncertainties => political divergences => financial costs => inhibiting growth => debt unsustainability => social rejection of EU and € => political conflicts => EU itself at risk**

Chart 6: Benchmark 10-year government bonds



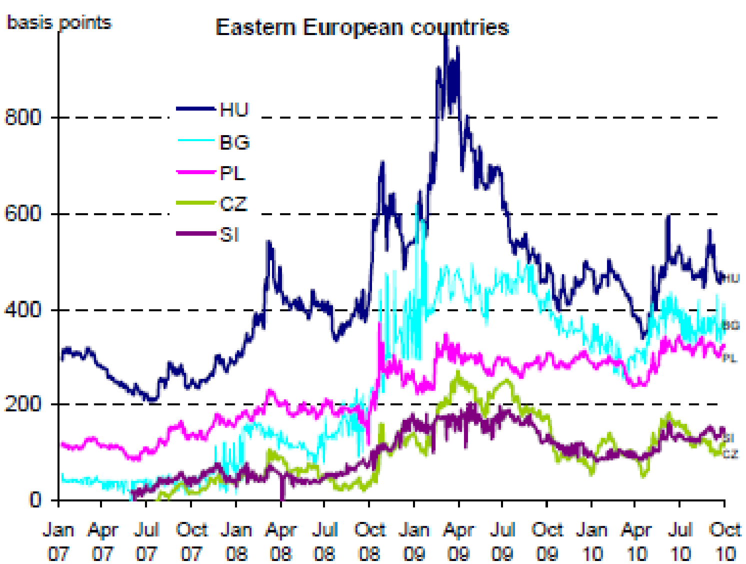
Source: EcoWin

Chart 7: Sovereign bond spreads to German bund



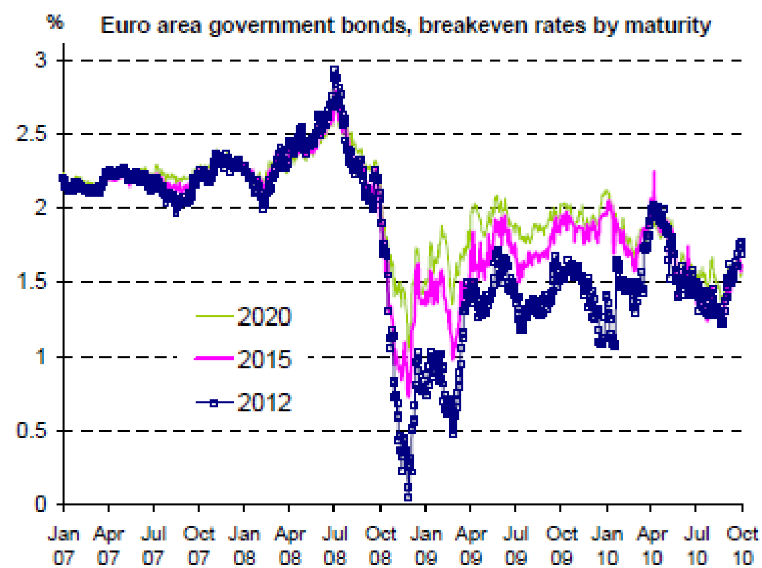
Source: EcoWin, own calculations

Chart 8: Sovereign bond spreads to German bund



Source: EcoWin, own calculations

Chart 9: Implied inflation expectations - euro area



Source: EcoWin

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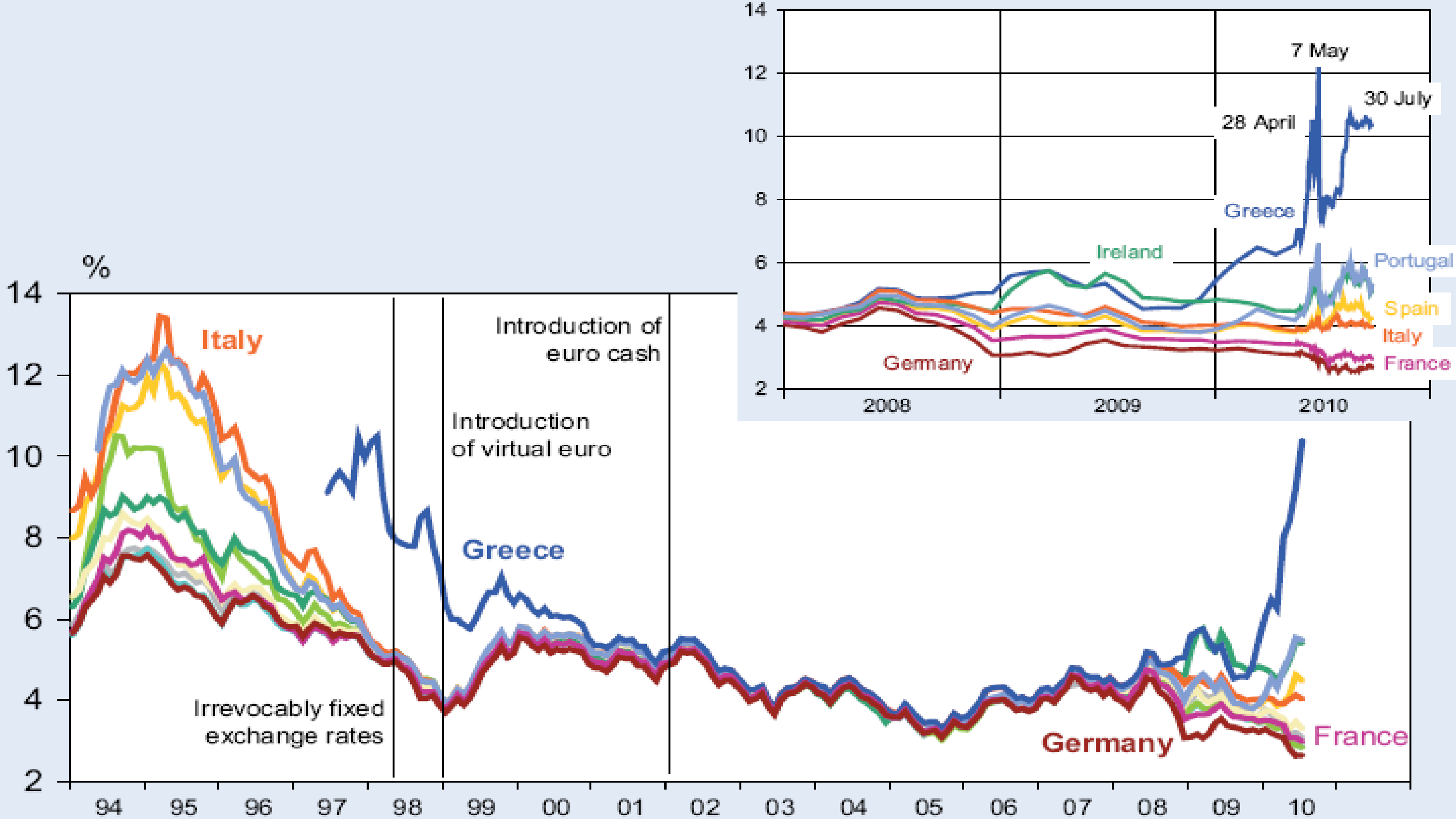
Interest Rates for 10-year Government Bonds



Source: Reuters Ecowin, *Government Benchmarks*, *Bid*, *10 year*, *yield*, *close*, 2 August 2010.

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The €-area crisis has just started

- But… EU uses to work at the last moment, pushed by necessity able to break the "Prisoner's dilemma"
- So, only solution is a fear-provoked policy consensus enabling realistic governance reforms (no time for radical Treaty changes but pragmatic ones in the existing framework):
- 1) stronger fiscal rules
- 2) enforced by market sanctions,
- 3) create a lender of last resort subject to strict technical conditionality

In synthesis, the present € crisis is due to the breakdown of the conditions which had made possible to get out of the "prisoner's dilemma" of divergence risks

The €-area crisis brings lessons to Eastern European economies (Member or not)

- The unbalanced growth model followed by Eastern European countries shares some of the flaws which put the € area in danger
- The reasons are the same: excess of easy growth in an international context of easy-money and wrong risk-assessment => excess of debts, pro-cyclical fiscal policies, weak supervision and regulations, lack of regional surveillance

The euro-area crisis

1. The essential of the EMU political economy:

   (the ex-ante project)

What is EMU?

= A integration tool for reaching Treaty objectives of high growth and social cohesion (Art. 2), in spite of the EU being not a federation

This means creating the conditions for benefitting from a single currency in spite of not being able to get single fiscal and economic policy (subsidiarity is "*2-ways*")

EMU is built deliberately upon a fundamental asymmetry between the single monetary policy and decentralized fiscal and economic policies ("*currency without state*")

It can work as far as all national economic and structural policies are "common concern" (Art. 98) => "MS shall coordinate within the Council" (Art. 99)

But the Treaty let open most of the concrete means

Basic philosophy of EMU: integration and governance by rules

- The EU is not a federation and could not become it before decades, this means impossible to centralize more fiscal policies or to get an "economic government"
- The Delors' Report (1989) set up the consensual basis upon which the Maastricht Treaty was built:
- 2 Pre-conditions for a sound € to fulfil ex-ante: nominal convergence and macroeconomic stability = low inflation and sustainable fiscal positions
- Therefore, a single currency needs an economic union = EMU = policy regime change in order to make up for most of the asymmetry by enacting rules for improving governance and coordinating national policies for preserving the common good ("cooperative competition" among MS, rule governance)

Δ K allocation

EMU => Δ Integration => Δ growth => social goal of EU

Δ Stability Δ job

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EMU and the € were conceived as catalysts:

1) A big step towards full EU integration (capital allocation, transaction costs, competition)
2) A progress in economic governance for making easier to warrant macroeconomic stability and predictibility
3) One of the main tools for meeting the goals of the EU: the two previous aspects are mutually supportive to EU integration; => to increase economic and social welfare of EU citizens

Indeed, the purpose of EU integration is (Art. 2 of the Treaty) « *to promote economic and social progress and a high level of employment and social protection…in particular through the creation of an area without internal frontier…and through the establishment of economic and monetary union…* »

The Political economy of the EMU: € as a win-win game…

Lack of nominal convergence impeded genuine integration with the single market: Germany with lower interest rates but overvalued, others with high risk premium incorporating expected depreciations (high spreads) => less capital integration, less growth

It is Germany interest to "sell" its credibility to other MS against nominal convergence discipline for stabilizing its area macroeconomic and R conditions (preventing DM overvaluation and depression of its main markets)

It is other MS interest to benefit from German credibility and discipline conditions for removing R and r uncertainty/spreads,

⇒ Higher growth for all if G trades off its DM for stability

The Political economy of the EMU: € as a win-win game…

⇒ A single currency makes this possible but not warranted (if rules are violated afterwards)

⇒ € should allow for removing R uncertainty by extending for free German credibility against nominal convergence conditionality and rule-coordination for maintaining it: => fast eradication of the spreads = integration of capital markets => Δ investments = Δ growth

This is a win-win game only if nominal convergence i.e. if spreads reflected unfounded depreciations and not default risks due to mismanagement and lack of surveillance

So € is a necessary condition but not a sufficient one

... as a bicycle: you move faster only by making up for imbalances by pedaling...

The euro was conceived as a tool which could be « well-used » or « mis-used » according to the respect of the agreed rules and the quality of other economic policies and conditions for growth (institutions)

Adopting the euro should improve the conditions for getting a higher growth as far as it improves integration, macroeconomic stability and predictability (necessary conditions for growth) but does not warrant to get it (not sufficient conditions)

€ provides a potential advantage, not a guarantee of results, only good governance makes the difference, but <u>€ increases the pressures </u>for good governance

…exposing the participants to new different risks …

The big difference between the € and other currencies is the 3 level asymmetry upon which it works:

1) Asymmetry in policy-level responsibilities: national fiscal combined with federal monetary policies
2) Asymmetry in the process: once inside it is very costly to get out (one-way move) but « win-win game » (higher growth + progressive OCA-creating)
3) Asymmetry in the results: « one-size-fits-for-all » exposes to moral hazard and divergent national results, and the mistakes by one have asymmetric impacts in time (short time gains/long run costs)

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…perceived as forcing national authorities to cooperate and to implement reforms

The EMU regime was conceived as an integration tool for strengthening endogenously the optimality conditions of an "OCA", spurring cooperation among competing Member States and forcing them to act together and to prepare rooms for manoeuvre for fiscal policies in their own national interests

As any investment, EMU regime opens to risks and returns, rational policy makers acting for optimizing their net results under the new constraint of being exposed to overvaluation risks without national monetary tool, but enjoying lower interest rates, higher credibility thanks to the support of the coordination process.

Net result were assessed to be positive thanks to the improvement in the credibility due to the Treaty dispositions

EMU policy regime…as it was conceived

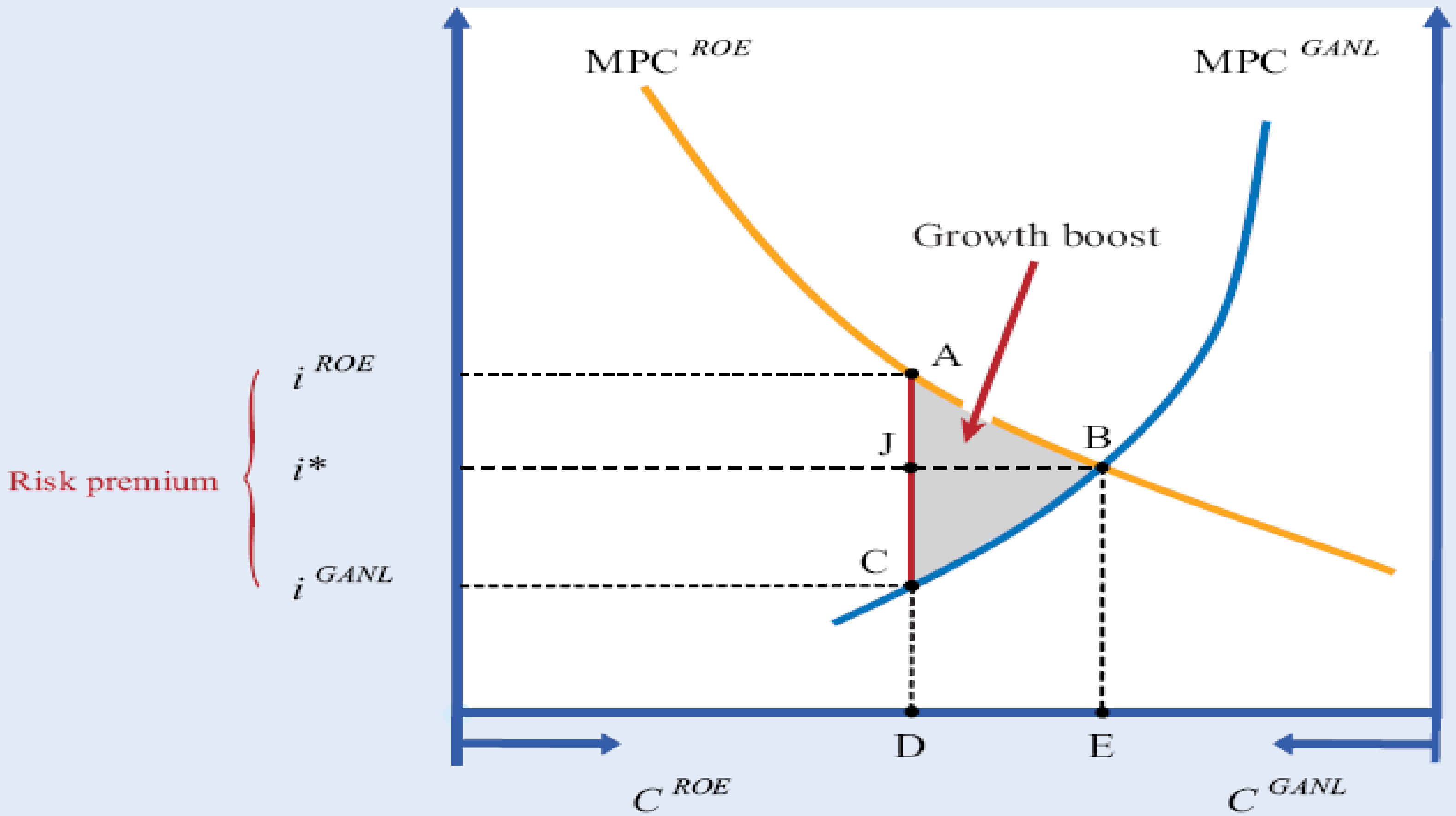
- EMU = Single monetary policy addressing price stability first + (rule-based) national budgetary policies addressing national cyclical, structural and social issues + other national economic policies
- EMU and the euro are in fact an (failed) attempt for tackling definitively the macroeconomic causes of the EU poor economic performance during the 70s and 80s (macroeconomic instability due to bad policies) by anchoring policies through a systemic improvement in economic governance thanks to the regional dimension (peer pressures)
- EMU was also indirectly viewed as a way to enforce further reforms (microeconomic ones) and political integration (by necessity for being efficient or preventing the worst)

The basic mechanisms at work in EMU

1. Comparative static analysis: Hans Werner Sinn’s charts: the expected net benefits of EMU and their sharing

2. Macroeconomic analysis: EMU and asymmetric shocks

Boost to Growth in Europe from the Euro: the Hope



Notes:

MPC^{GANL}	Marginal productivity of capital in Germany, Austria and the Netherlands
MPC^{ROE}	Marginal productivity of capital in the rest of the euro countries
i^{GANL}	Interest rate in Germany, Austria and the Netherlands if the euro had not been introduced
i^{ROE}	Interest rate in the other euro countries if the euro had not been introduced
i^*	Uniform interest rate in all euro countries after the introduction of the euro

Source: H.-W. Sinn and R. Koll, "The Euro, Interest Rates and European Economic Grwoth", *CESifo Forum* 1, No. 3, 2000, pp. 30–31

1. Expected results from the €: comparative statics (H. W. Sinn's chart)

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The horizontal axis = K available in the € area

The 2 curves = Marginal Product of capital (internal rate of return of investment)

Without €, spreads segmented K markets: D

With €, no spreads, re-allocation of K from D to E = DE capital exports from GANL (DM area) to ROE (mainly periphery, i.e. Spain, Greece, Ireland, Portugal)

⇒ Net GDP gains = ABC = ABED (Δ growth for ROE)- CBED (∇ growth for GANL) = JBC + ABJ:

⇒ Net income gains for GANL = JBC = JBED (return from FDI) – CBED (output losses)

⇒ Net income gains for ROE = ABJ = ABED (Δ output) – JBED (interest costs paid to GANL)

These positive results rely upon good governance

These expected result would be <u>effective only if interest rate spreads were unfounded</u> i.e. if they were due only to R risks, = Treaty and governments would make sure fiscal policies are sound, private sector debts are also sustainable, or, in fact, if cost/price development would be right.

In case of mismanagement => € single interest rates would just hide risks => no spreads for a while => biased interest rates => perverse results: misallocation, overheating, bubbles and solutions would be much more costly (due to € asymmetries)

But government mismanagement highly probable (free-riding), therefore «<u>Stability and Growth Pact» + «German police</u>»

For private sector development, a dogmatic hypothesis that private sector is stable by itself, hided risks

Negative results from the € in case of no discipline Sinn's analysis (German position)

If ROE does not respect the rules => nominal r convergence = real expected rate divergence, biasing investment and creating overheating

With €, no nominal spreads but a (perverse) real effective spreads:

r GANL > r ROE => too much K imports and FDI in ROE, miscalculation of Investments = wrong K allocation => pro-cyclical policies = loosening private and public budget constraints => credit boom + competitiveness divergences = unsustainable imbalances

=> Δ growth ROE < ∇ growth GANL = net losses for € area

⇒ BGHE (Δ growth ROE)- BFHE (∇ growth GANL) = -BFG

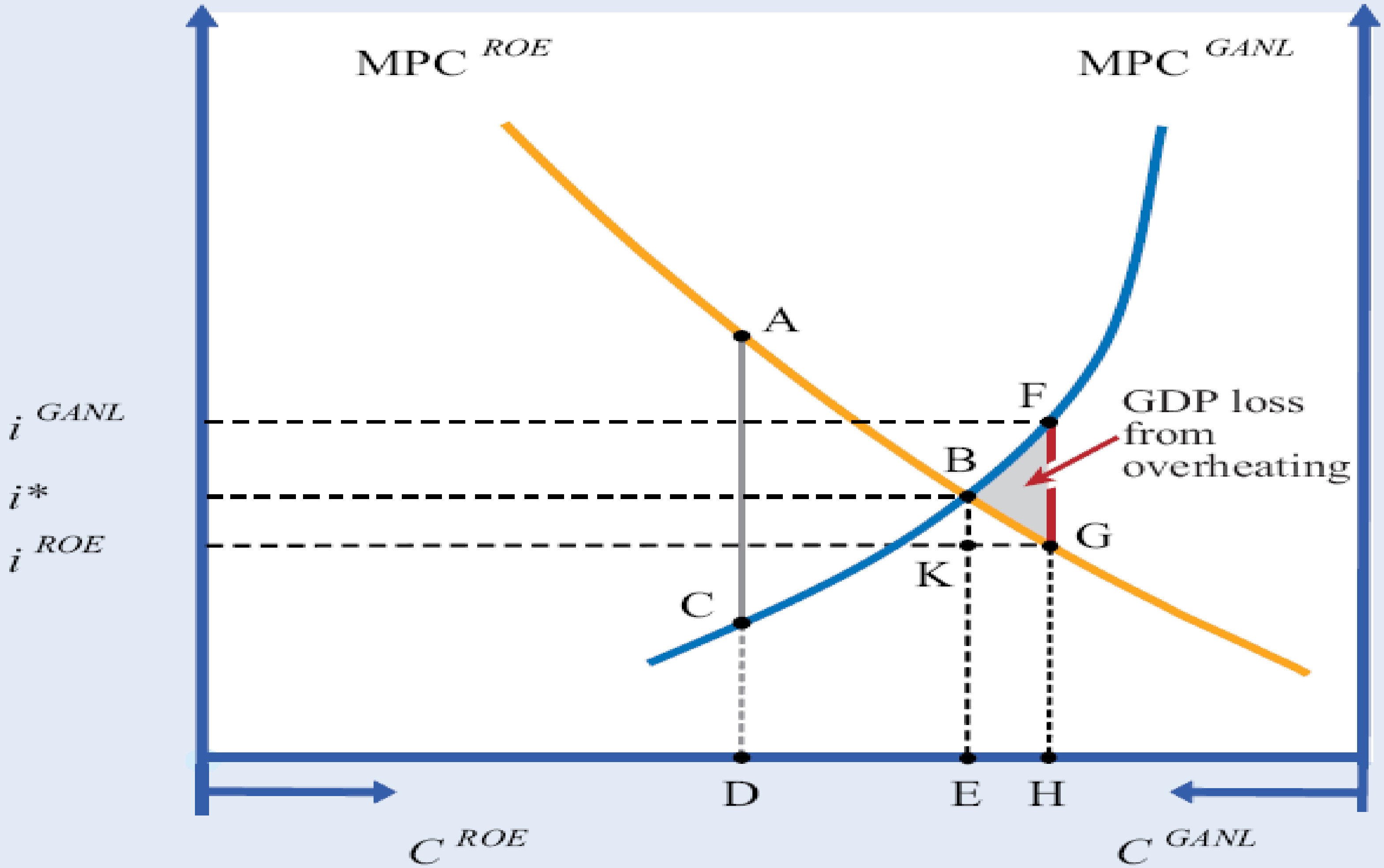
⇒ BGK = Net income gains for ROE = BJK = BGHE (Δ output by FDI) – KGHE (interest paid on imported K)

⇒ -BFGK= Net income losses for GANL = KGHE (interest received) – BFHE (∇ growth GANL)

⇒ Total €-area losses from overheating = BFG = BGK-BFGK

⇒ = Total disaster: the € would become dangerously conflictual

EXCESSIVE CAPITAL IMPORTS: THE BUBBLE



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2. The macroeconomic mechanisms in a monetary union

- Costs arise because, when joining monetary union, a country looses its own monetary policy instruments (interest and exchange rates)
- This is costly when asymmetric shocks occur, but monetary union tends to reduce this occurrance as far as convergence conditions are respected (so with effective EMU discipline)
- If free-riding => monetary union creates unsustainable costs for all members

The basic mechanism in a monetary union

- The texbook cases of asymmetric shock can be read here as “endogenous shock” resulting from bad governance and wrong fiscal policies (leading to present cyclical divergences)
- Asymmetric shock in demand: example
  - Decline in aggregate demand in France
  - Increase in aggregate demand in Germany
  - Need to distinguish between permanent and temporary shock
- Let’s see this shock in two opposed regimes
  - Monetary union
  - Monetary independence

Recession in France: Df downwards shift => Pf down
Expansion in Germany: Dg upwards shift => Pg up

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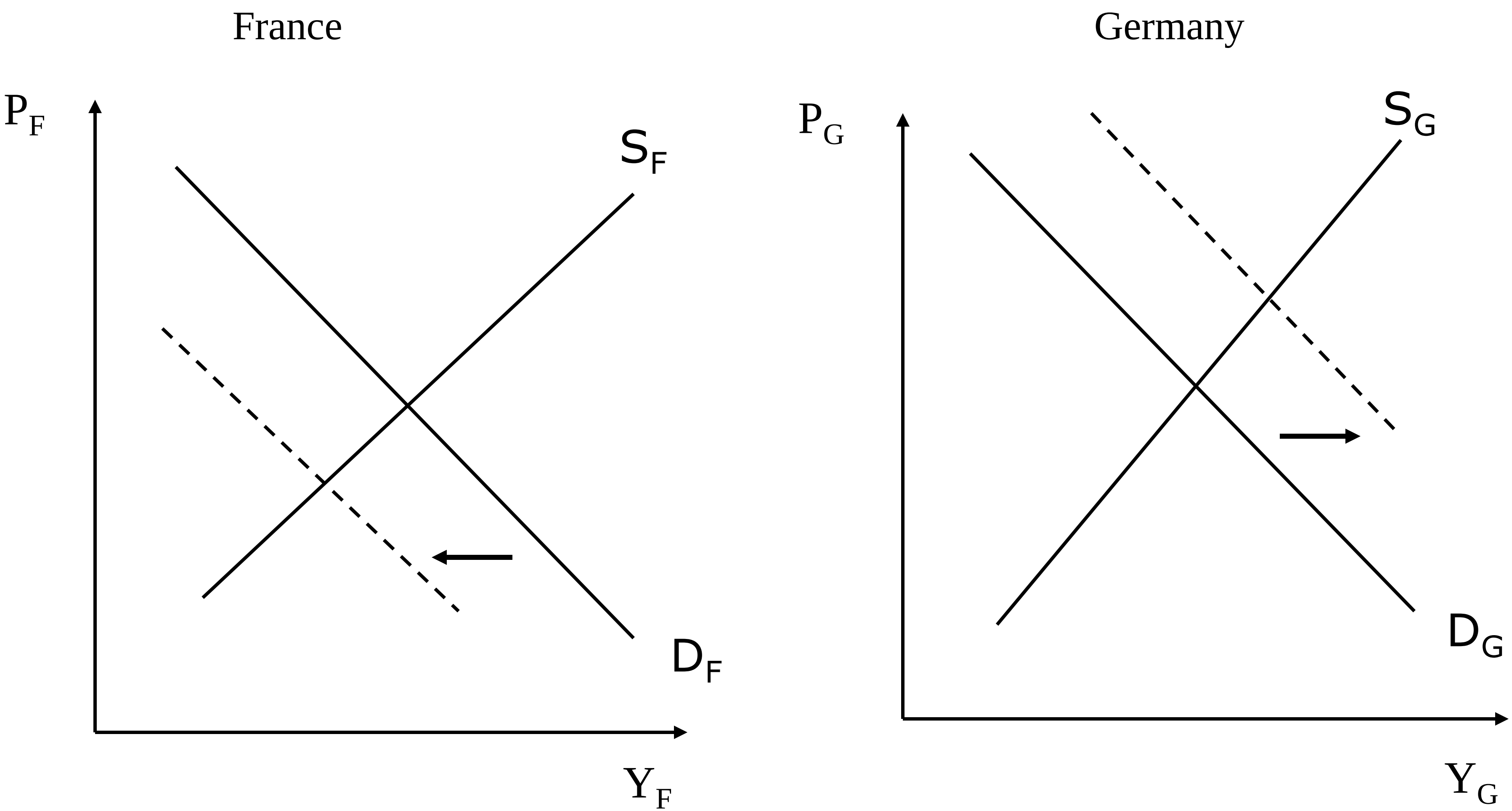
Figure 1.1 Aggregate demand and supply in France and Germany



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In a Monetary Union between France and Germany

France cannot stimulate demand using monetary policy; nor can Germany restrict aggregate demand using monetary policy

There exist alternative (theoretical) adjustment mechanisms in monetary union:

1) National Fiscal policies can make up for monetary policy effect on aggregate demand if there is fiscal room for manoeuvre in both economies (some implicit coordination)
   - Aggregate demand in France shifts back upwards
   - Aggregate supply in Germany shifts back downwards
2) Wage flexibility
   - Aggregate supply in France shifts downwards
   - Aggregate supply in Germany shifts upwards
3) Financial integration (increased by the EMU) allows for redistributing purchasing power from surplus towards deficits
4) Labour mobility (very limited in the EU)

With EMU and coordinated fiscal policies:
Δ fiscal deficit in France => Δ aggregate demand
∇ fiscal deficit in Germany => Δ aggregate demand

Figure 1.2 Effects of fiscal expansion in France coordinated with fiscal contraction in Germany (<u>temporary shock</u>)

France Germany

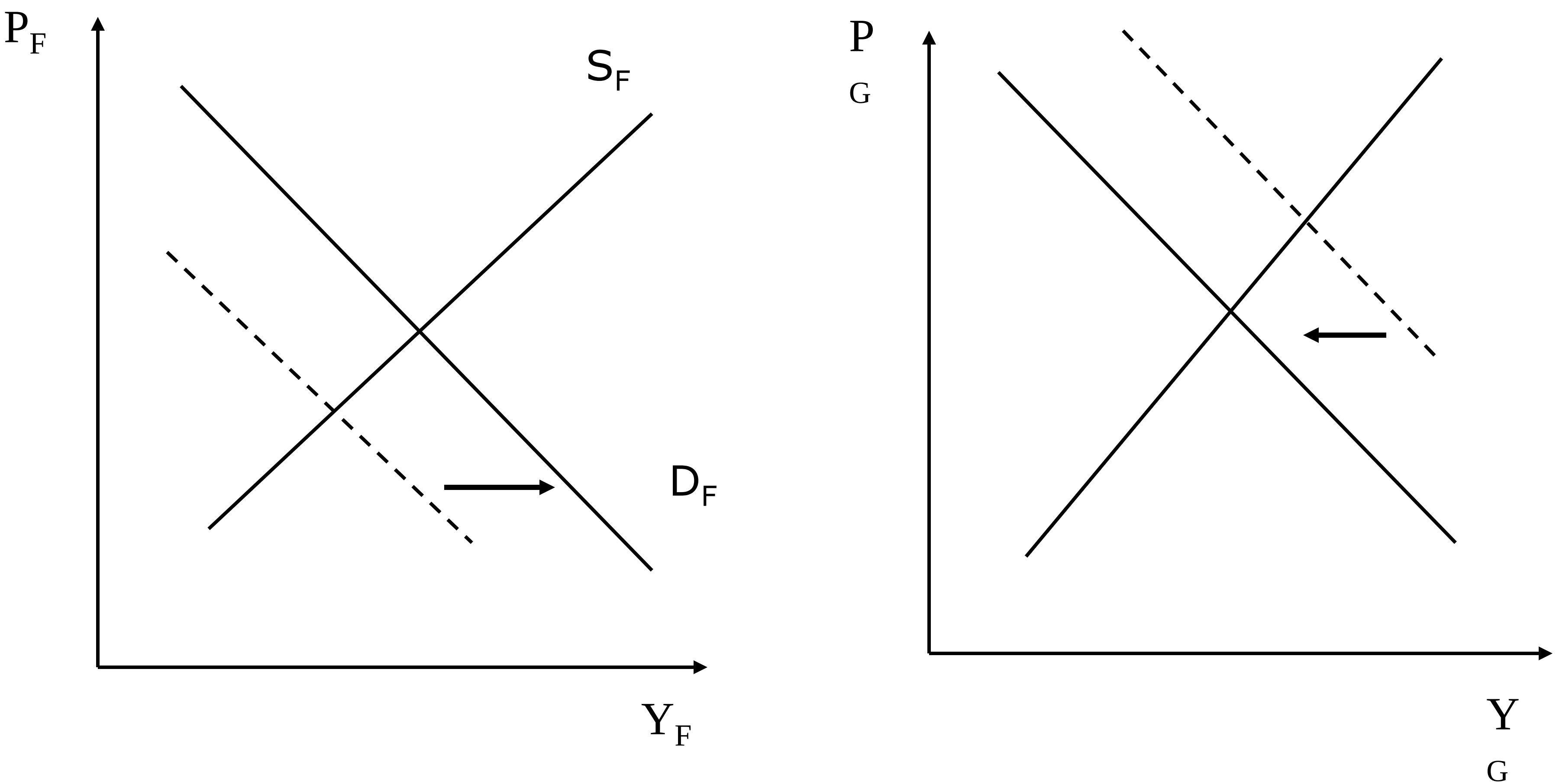
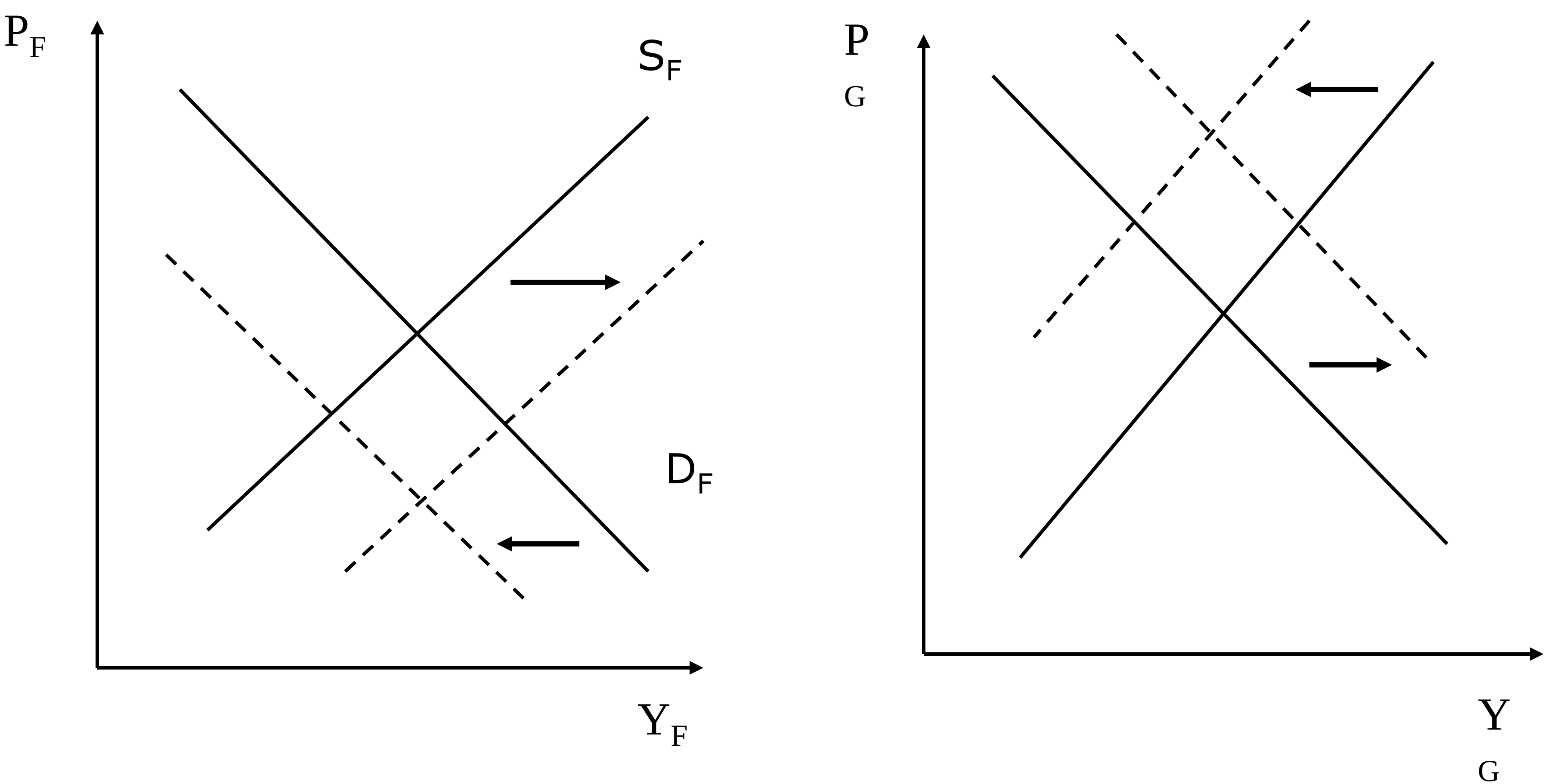


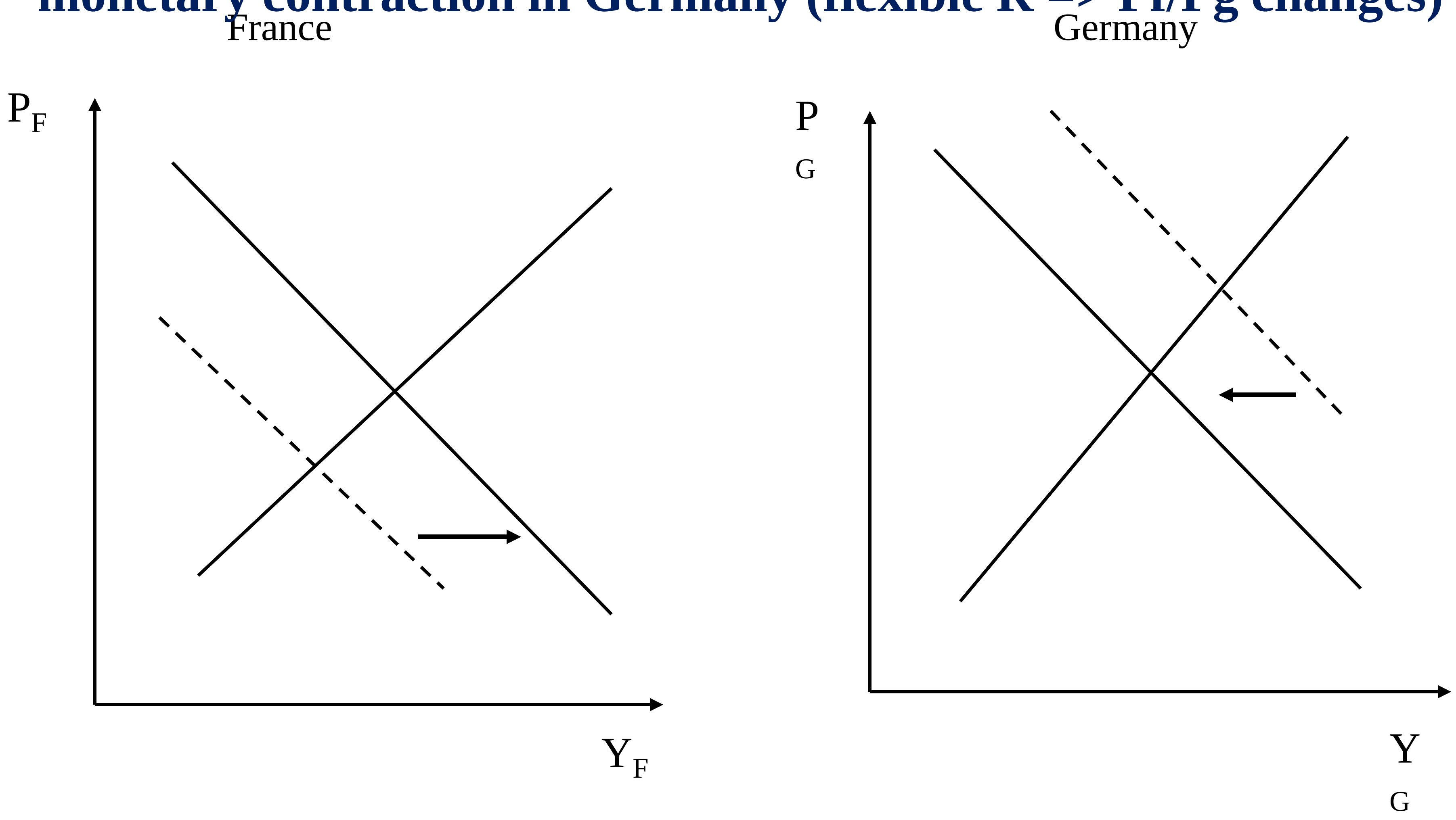
Figure 1.3 The automatic adjustment process by real exchange rate adjustment (nominal R fixity => ▽ Pf/Pg, <u>permanent shock</u>)

France Germany



With national currencies (no EMU):
Δ Ms in France => nominal depreciation
∇ Ms in Germany => nominal appreciation

Figure 1.4 Effects of monetary expansion in France and monetary contraction in Germany (flexible R => Pf/Pg changes)



CONCLUSIONS of the ex-ante project

- EMU tends to reduce risks of asymmetric shock
- EMU without discipline => permanent asymmetric shock
- When shocks are asymmetric
  - monetary union creates costs compared to monetary independence
  - Common central bank cannot deal with these shocks
  - Fiscal policies are limited (and difficult to coordinate)
  - Structural supply side policies needed (reforms)
- When shocks are symmetric :
  - Monetary union becomes more attractive compared to monetary independence
  - Common central bank can deal with these shocks
  - Monetary independence can then lead to conflicts and 'beggar-my-neighbour' policies, uncertainty creates unnecessary spreads

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CONCLUSIONS of the ex-ante project

Therefore, EMU was voluntarily conceived as a costly option in case of asymmetric shocks if no wage flexibility and lack of fiscal discipline (loosing fiscal room for maneuver) in order to make policymakers more responsible

However:

1) asymmetric shock are not current and suppose to be reduced by the EMU itself
2) Fiscal room should result from the "Stability and Growth Pact" (1997)
3) Structural reforms should result from the need for more flexibility, bringing it

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The euro-area crisis

2. **The ex-post EMU: the first decade impressive success made policymakers too benevolent…**
3. …turning into mistakes and contradictions

2. EMU's achievements up to 2008…

Elimination of **exchange costs** and currency fluctuations

Price transparency and comparability

- Increased competition within the single market

Price stability and low interest rates:

- Consumer borrowing less expensive
- Encourages business investment: growth and jobs

Spectacular **job creation**, boosted by the Lisbon Strategy

Building a **European identity**: political integration

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EMU’s achievements up to 2008…

(Apparent) Sound **fiscal positions** (result of higher growth)

Greater **resilience to external shocks**

Increased economic and financial **integration**

Greater **synchronisation of business cycles**

Major **international currency**

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Inflation performance improved

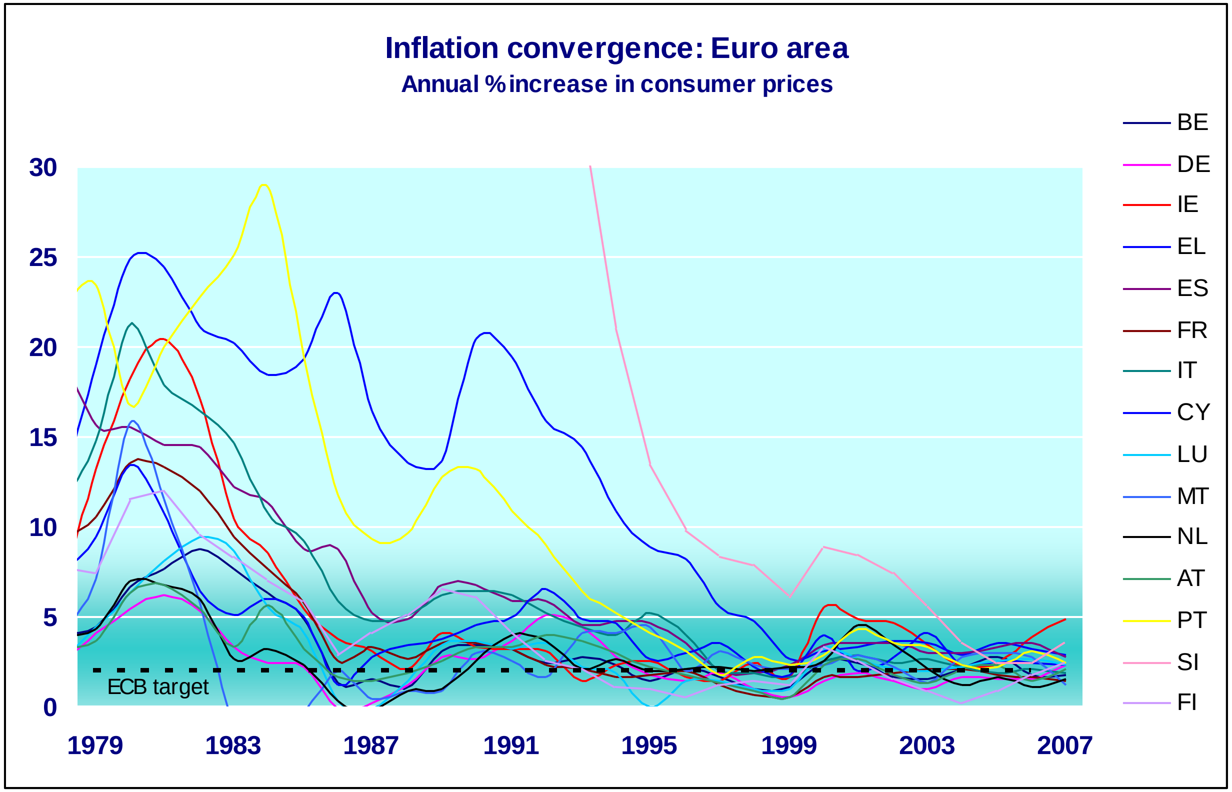
Table 1: **Inflation performance in the euro area**

	Average inflation	Standard deviation of inflation	Maximum inflation	Date of max. inflation
1960s	3.7	0.9	5.1	1963
1970s	9.3	2.8	13.6	1974
1980s	7.5	3.8	12.8	1981
1990s	2.8	1.2	5.0	1990
2000s*	2.0	0.3	2.4	2001

*Corresponds to the period since the start of Stage III of EMU, of which the last 2 years are forecast values.

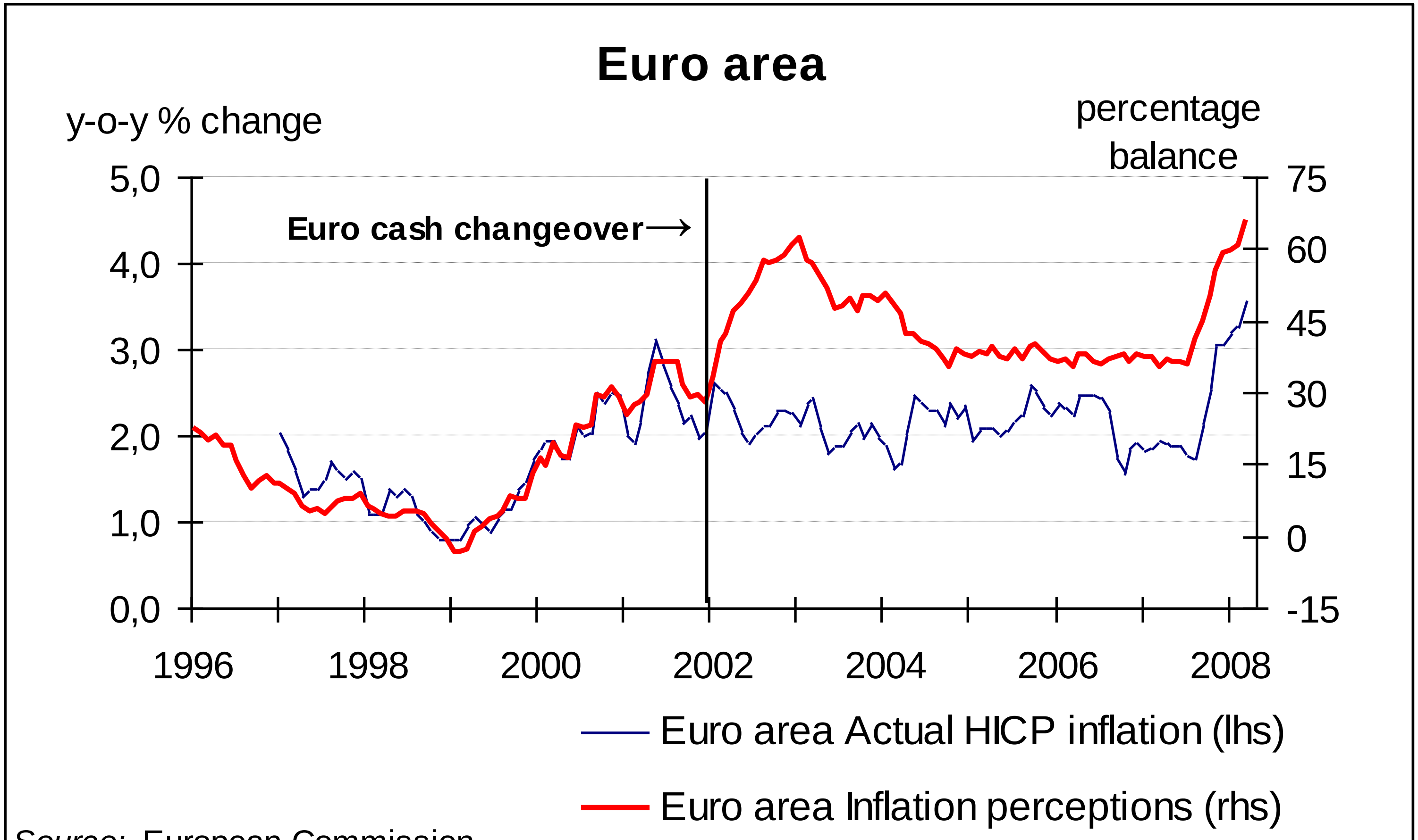
Source: European Commission.

Inflation performance improved



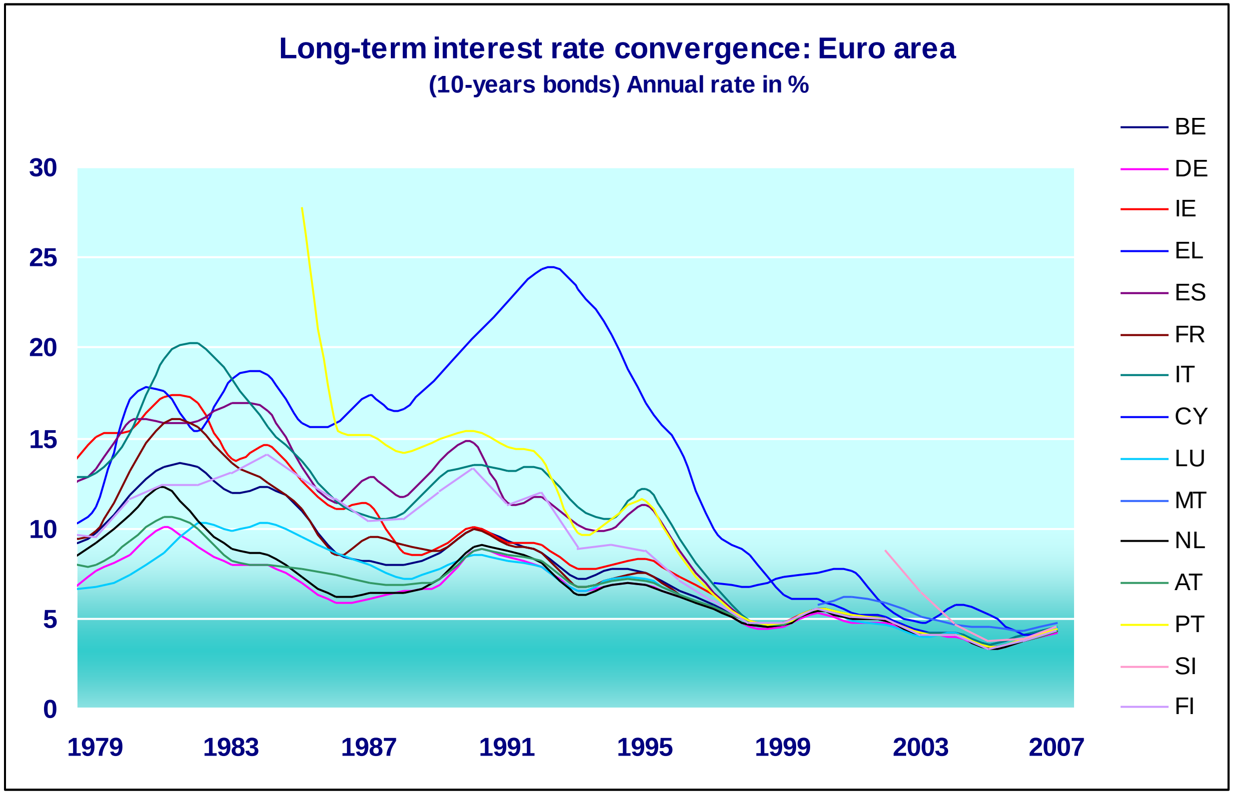
Source: European Commission

Price perceptions in the euro area



Source: European Commission

Lower long-term interest rates



Source: European Commission

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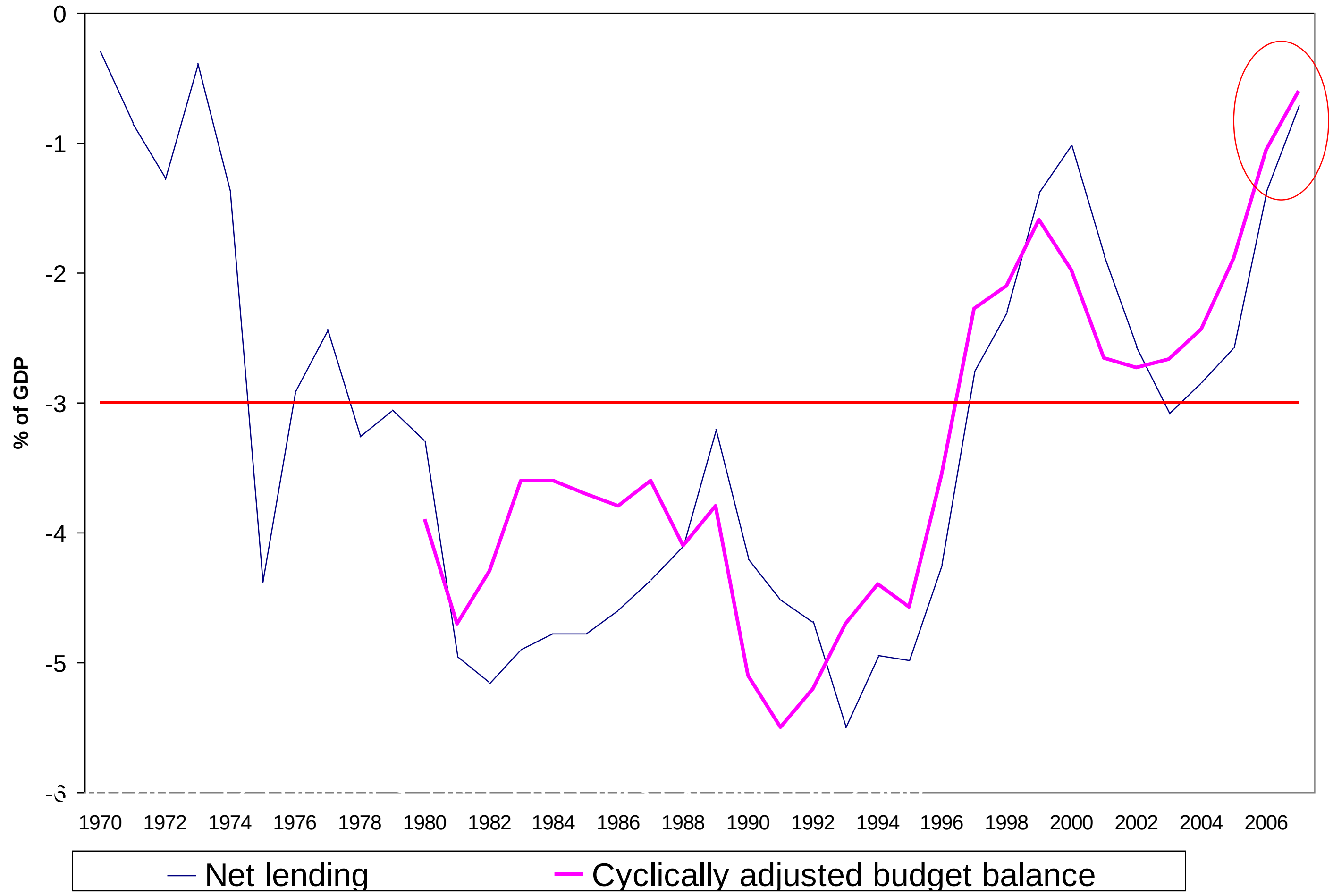
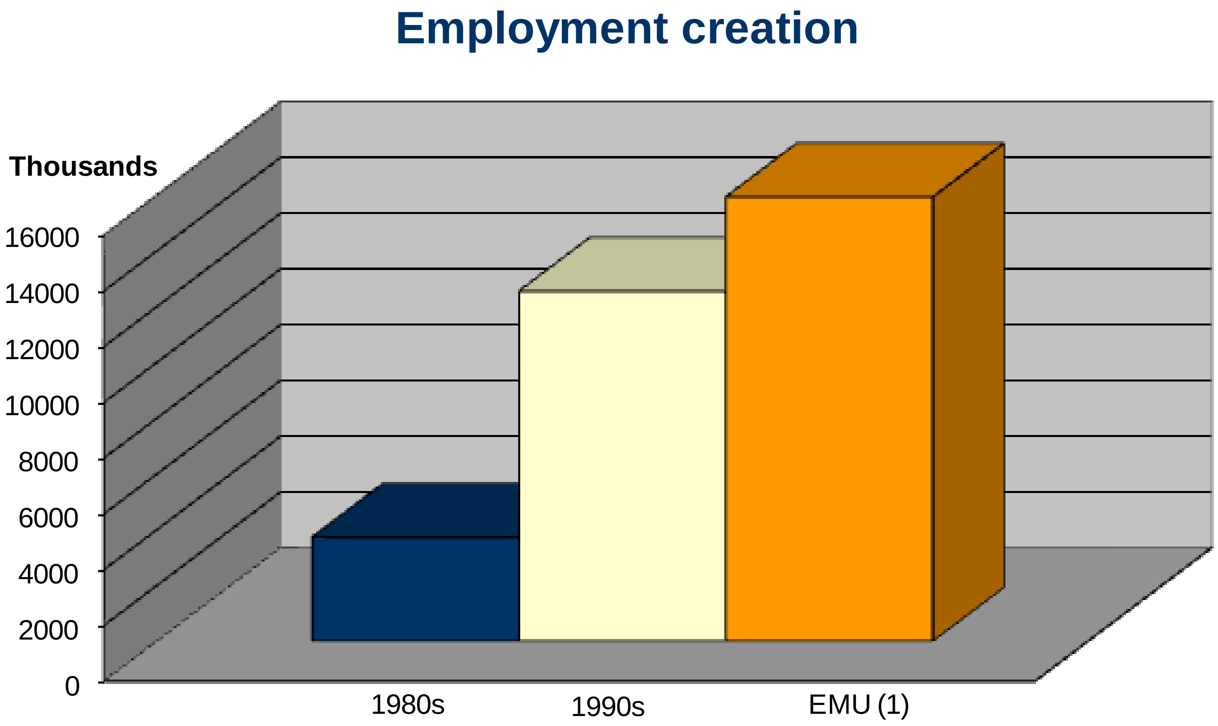
Fiscal consolidation

Budget balance and cyclically-adjusted budget balance (1970-2007)

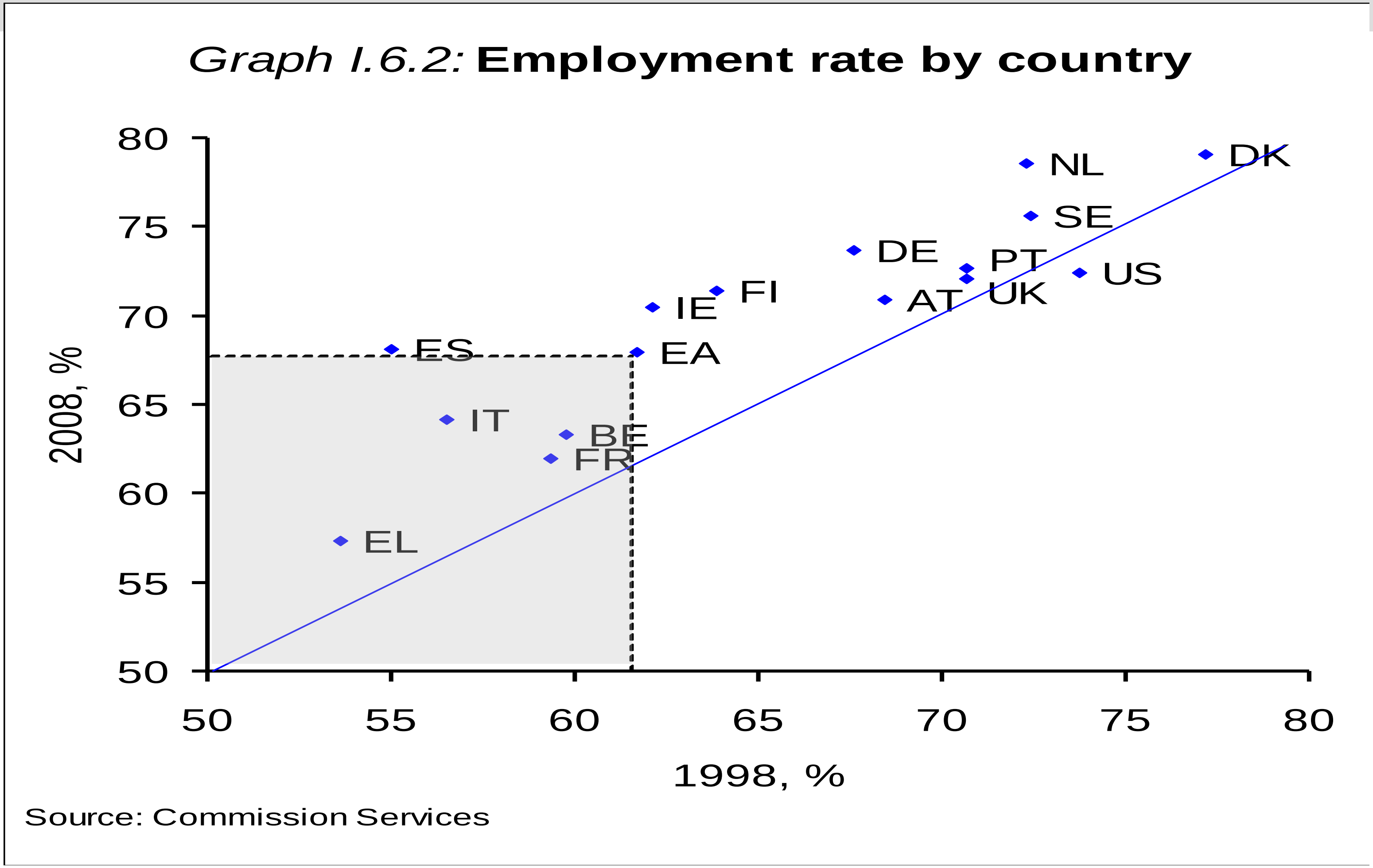


Employment received a major boost

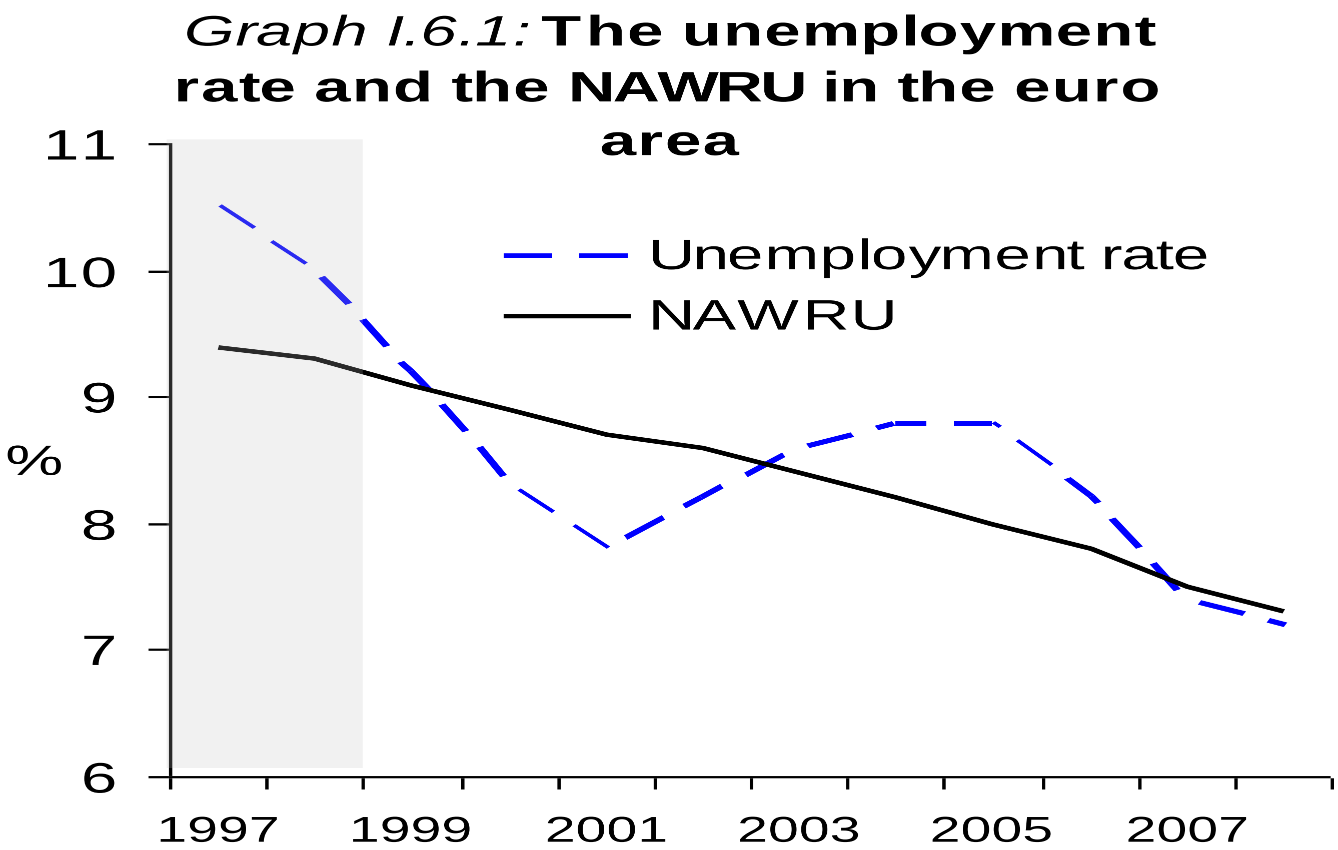


(1) EMU corresponds to euro area-12 countries and covers 1999-2007

Employment rates soared across the board



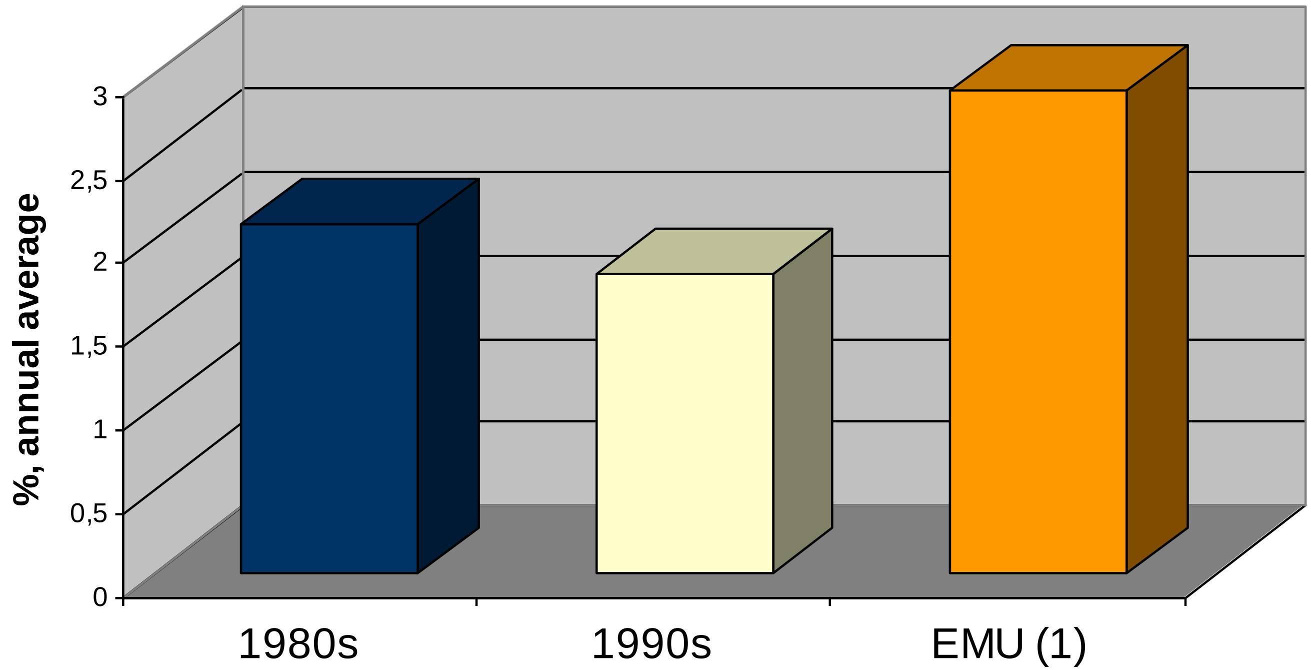
Unemployment steadily declined



Source: Commission Services

A catalyst for investment

Gross fixed capital formation in the euro area*



(1) EMU corresponds to euro area-12 countries and covers 1999-2007

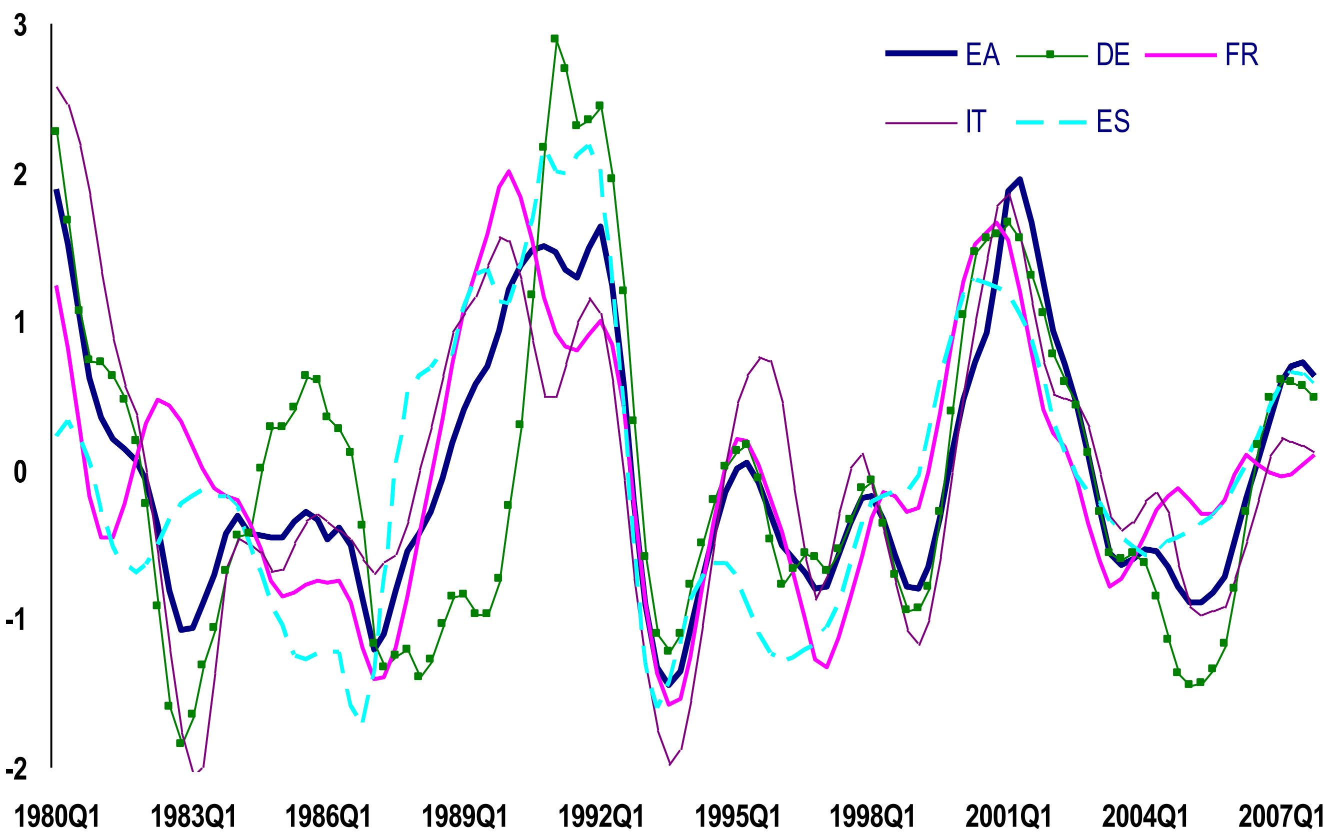
* The graph refers to gross fixed capital formation in the public sector

Increased financial market integration

Bigger markets, more efficient allocation, greater opportunities for risk sharing:

- In equity markets **'home bias' declined** from 80% to 60% since 1999
- **Cross-border** holdings of EA L-T debt securities from around 15 % to 57% of total (2005)
- **Banking sector** consolidated and reinforced its cross-border linkages (assets) during EMU

Greater synchronisation of business cycles in the euro area



* EA = Euro area; DE= Germany; FR = France; IT = Italy; ES = Spain

A growing international role

- Increasingly used to issue **government and corporate debt** worldwide
- Second most actively **traded currency** in forex markets
- **Invoicing** in € represents more than 50% of the external trade of the euro area
- Attractive **reserve currency** for other countries

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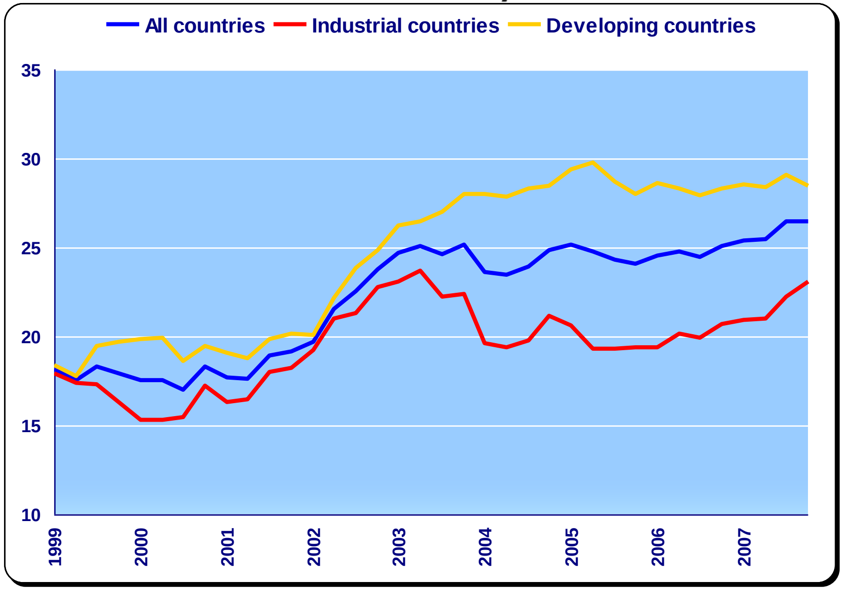
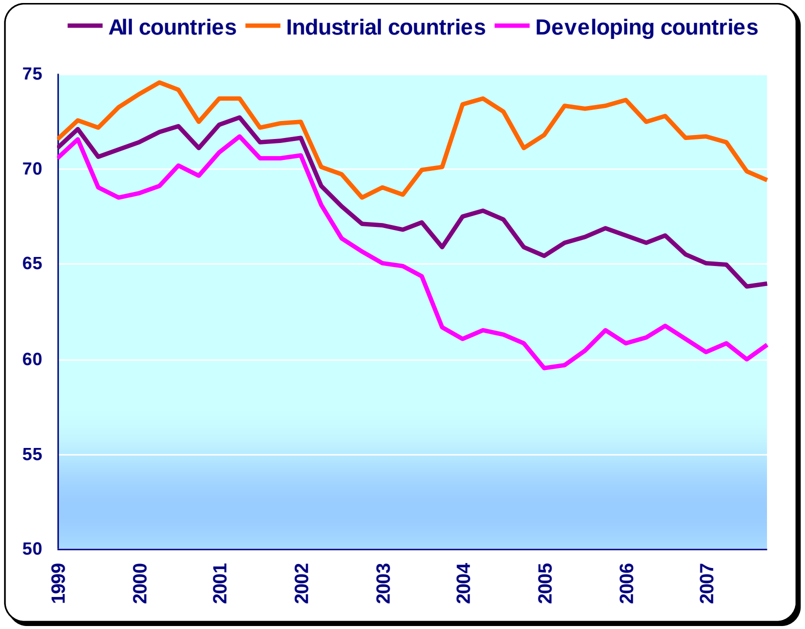
A growing international role

The euro as a reserve currency



The dollar as a reserve currency

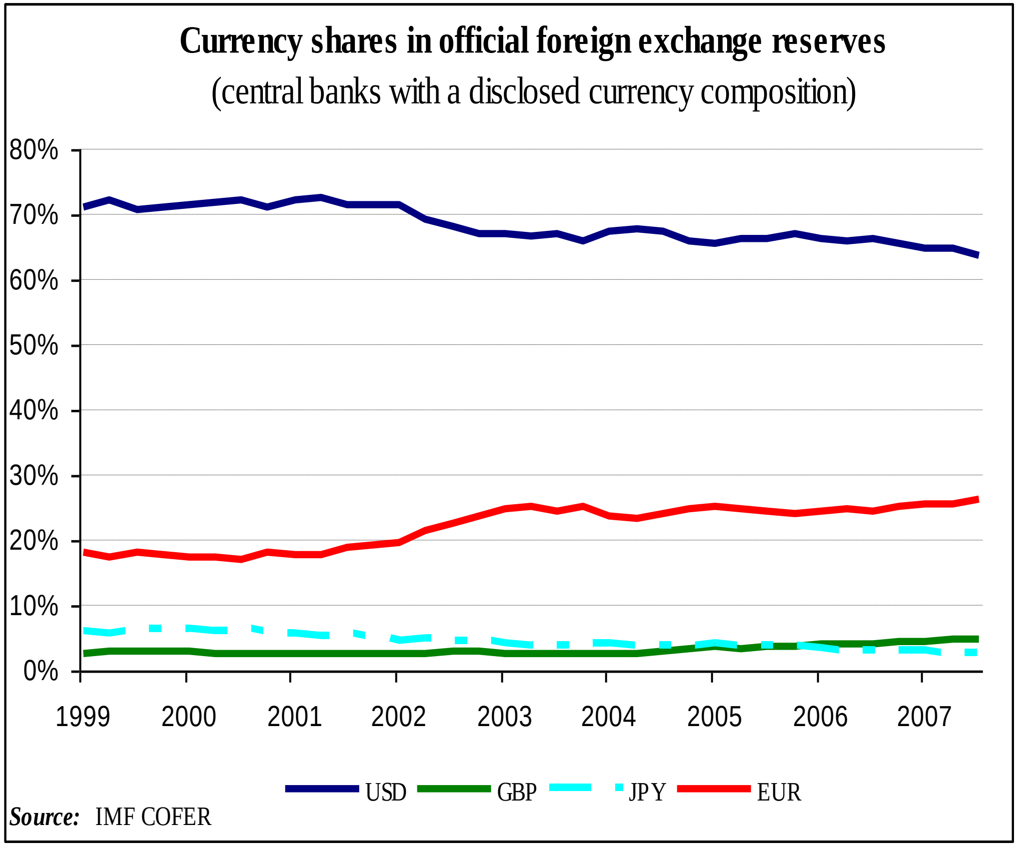


% of allocated reserves

Source: International Monetary Fund

A growing international role

Official forex reserves



- €-share ≈ 26%
- $-share ≈ 64%
- Some diversification out of $ into € since 1999
- Particularly in countries with close economic and institutional links to the euro area
- € less important in Asia, the Americas and countries with dollar pegs
- IMF COFER data cover only central banks that disclose their currency composition (e.g. China not included)

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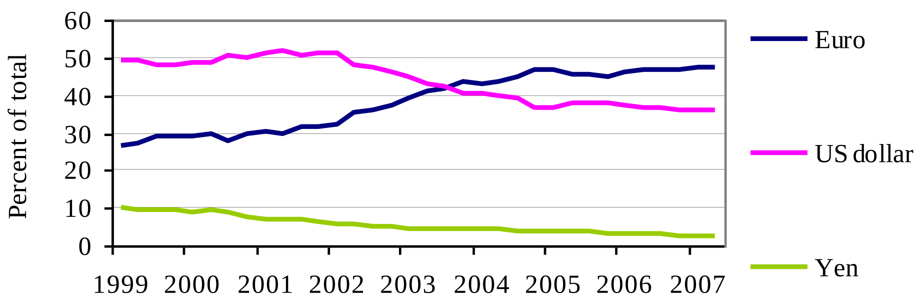
A growing international role

International debt securities

Stock of international debt securities: currency shares (broad measure)

(including home currency issuance if targeted to international market, percent of total amount outstanding, at current exchange rates)



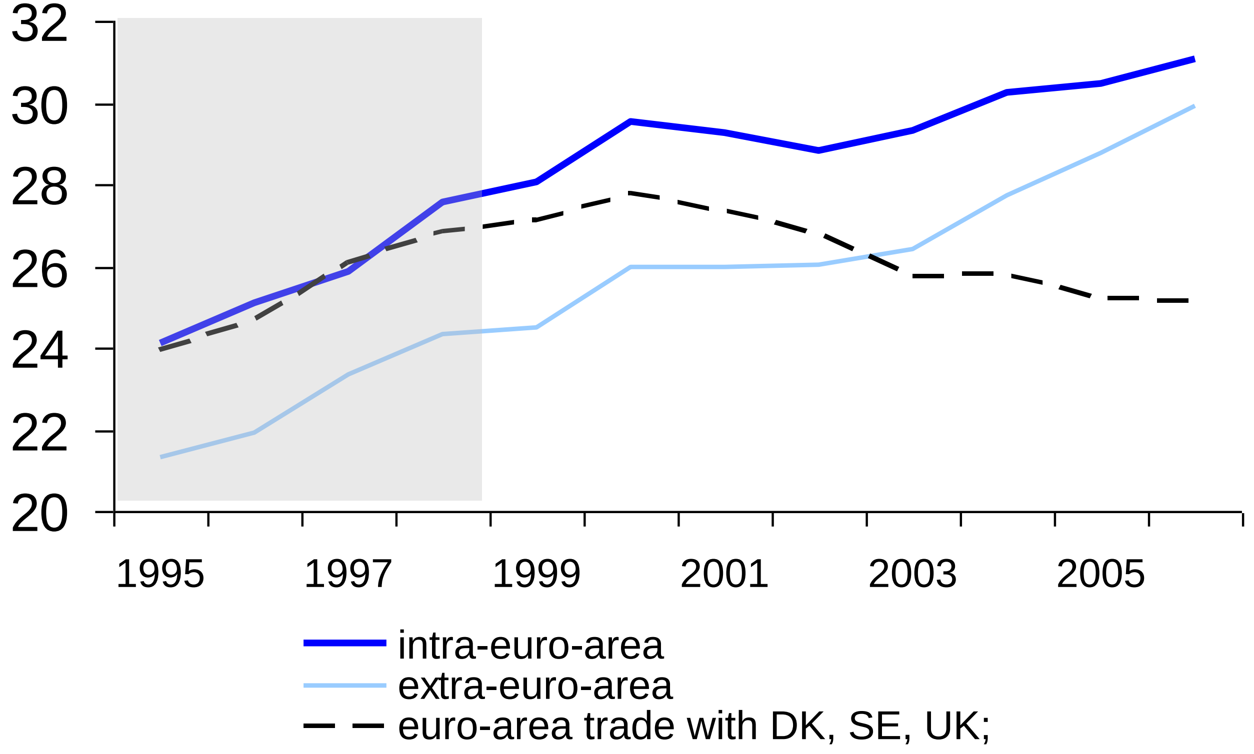
Source: BIS

- €-share ≈ 47%
- $-share ≈ 36%
- Significant shift into € since 2002
- Large, integrated and liquid euro-area financial markets
- International diversification

A catalyst for trade

Real trade in goods (1995-2007)

Sum of exports and imports as a % of GDP



***Source*: European Commission**

A catalyst for trade

Trade and cross-border activity supported by macroeconomic conditions:

- Intra-euro-area **trade flows** rose from 27.5% of GDP in 1999 to over 31% in 2006

- Intra-euro-area **foreign direct investment flows** increased from 20 to 35% of total FDI

The euro-area crisis

2. The ex-post EMU: the first decade impressive success made policymakers too benevolent...
3. **...turning perverse the inner logics of the € making it to develop (public and private) governance errors and bubbles**

But…behind the impressive success, an accumulation of imbalances and divergences developed all the more…

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1) Markets and rating agencies trusted too much the EMU regime => no more risk premium on sovereign bonds (wrongly attributed only to devaluation option and not to risk of default),
2) First decade brilliant achievements masked the other risks => too complacent policymakers, making impossible for the Commission to play its role (example of Spain: how to explain that Spanish surplus was artificial when Spain was given as example!)
3) Free-riding of all governments, inclusive Germany! (INCENTIVES FOR FISCAL DISCIPLINE WEAKER with a single currency
4) Commission powerless and under national control

…that no pilot was in the plane and that the US$ IMS generalized the Fed easy money stance…

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5) Even when Commission attempted to react (2003), EU Council being "**judge & part**" did oppose and violated the Treaty and the Pact

6) ECB too expansionist as a result of the $ pressures (€ appreciation) and the emerging countries appetite for exchange reserves, reinforcing the credit-boom

⇒ Excess of borrowing and debts (public and private)

⇒ Overheating and excess of FDI in wrong sectors

⇒ Bubbles increasing temporarily fiscal incomes

⇒ Vicious circles spurred by dogmatic belief in self-stabilizing financial markets

…leading to the € deep crisis

⇒ inhibiting reforms => unsound development with strong imbalances => the ex-ante **EMU logics turned perverse** against the €:

Announced costs of the € did not appear but only its advantages, so they were used up by politicians (€ easy-money, no risk-premium, predator free-riding)

⇒ needed pressure for reforms and prudence did not materialized

Results: unsustainable fiscal positions + excessive divergences in prices, costs and current account + misallocation of K + private debt unsustainable =>public bailing-out of private sectors = making the € counterproductive or unable to work (the single monetary policy is going perverse) = **total disaster**

...which results in a deadlock

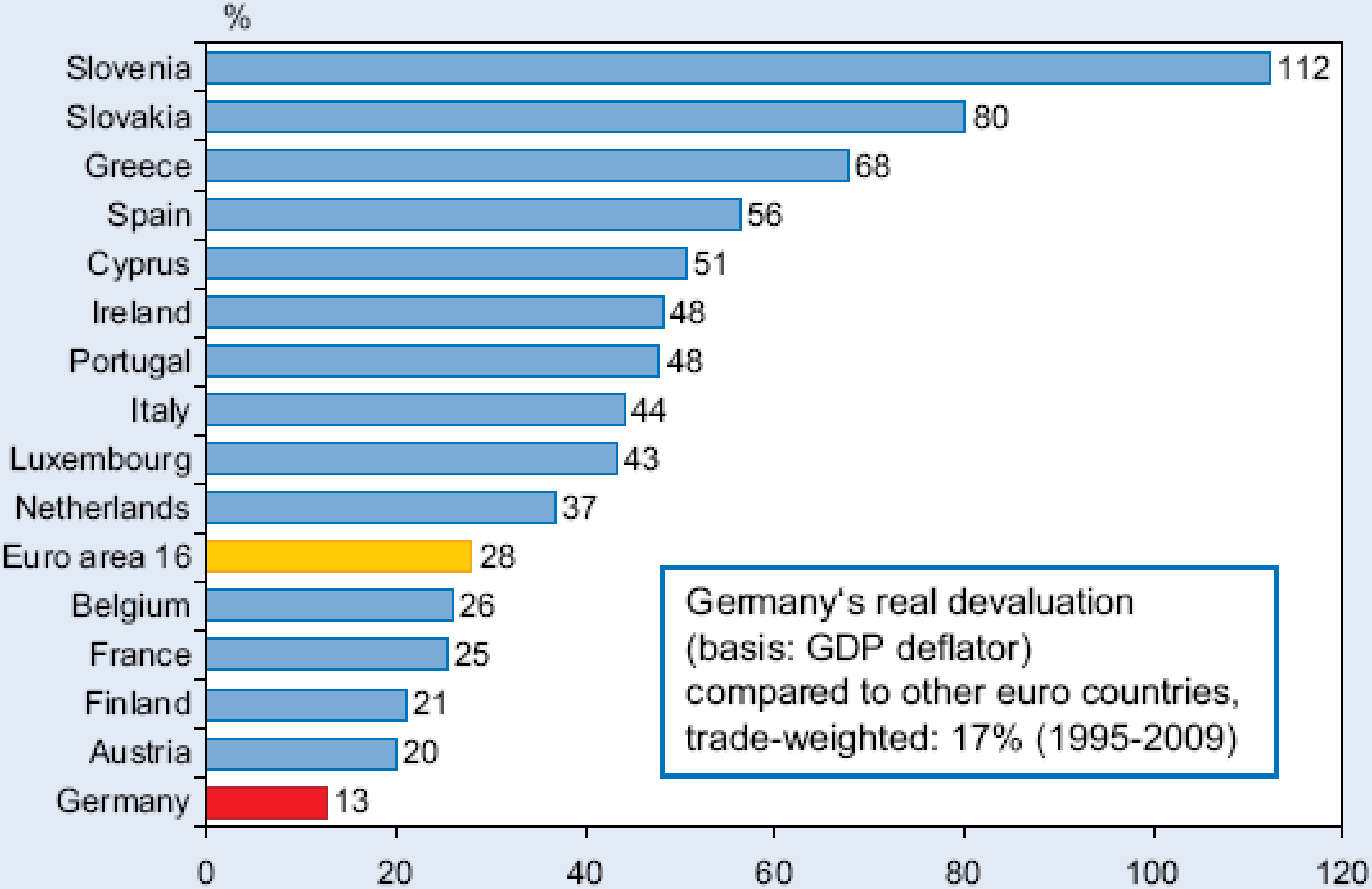
The most worrying is still to come: recent recovery figures show divergent recovery paths, with Germany up faster than indebted partners

<u>But the € was supposed to harmonized cyclical positions</u>

In divergent cyclical positions, the “one-fits-all” monetary stance cannot generate growth to indebted partners, worsening their debt crisis and spreads, and makes Germany more reluctant than ever to accept to use its fiscal room for manoeuvre for making up for the others failures (moral hazard argument)

=> political clash => return to national interest first in a typical prisoner's dilemma

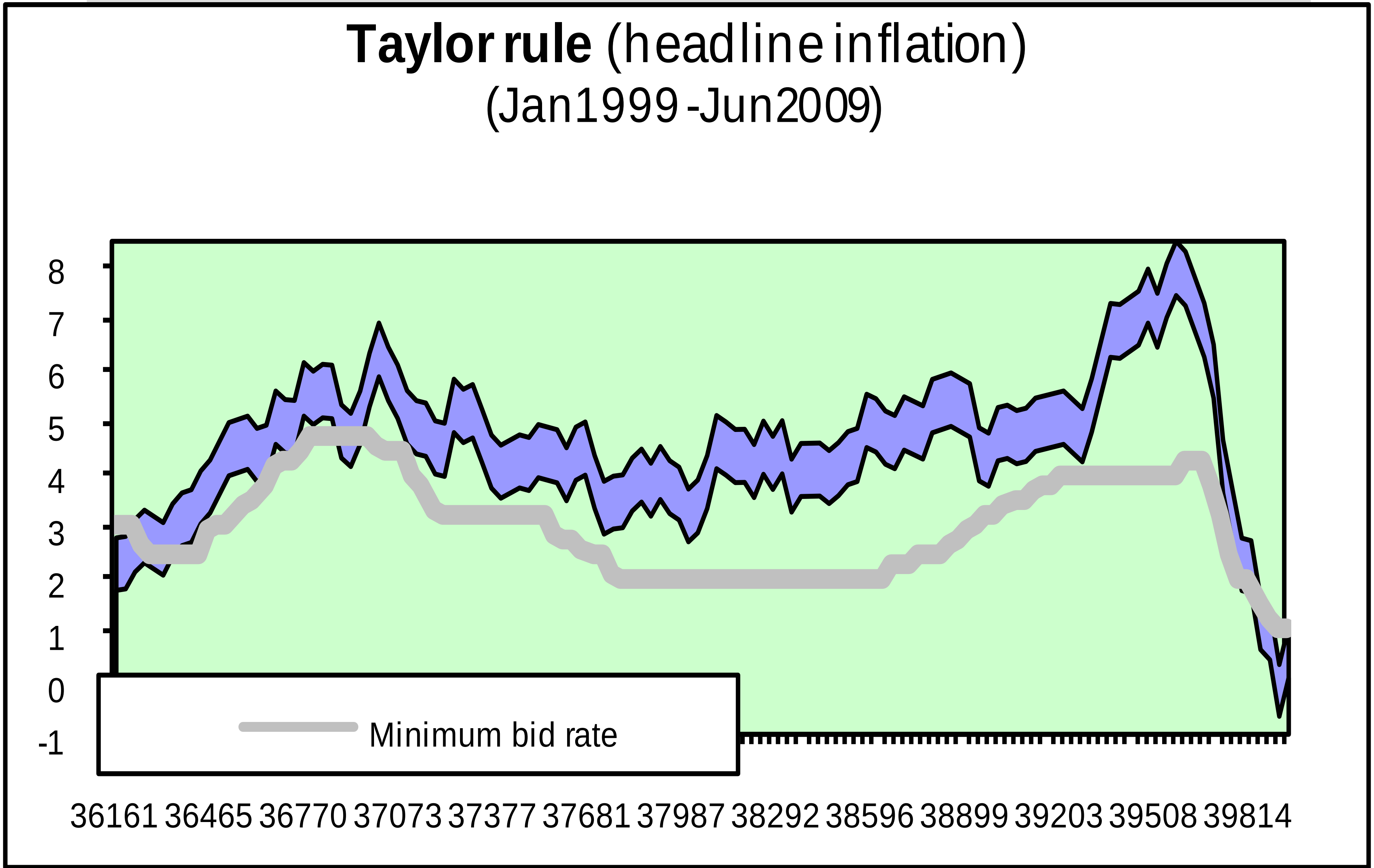
EURO INFLATION RATES (GDP DEFLATOR) 1995-2009



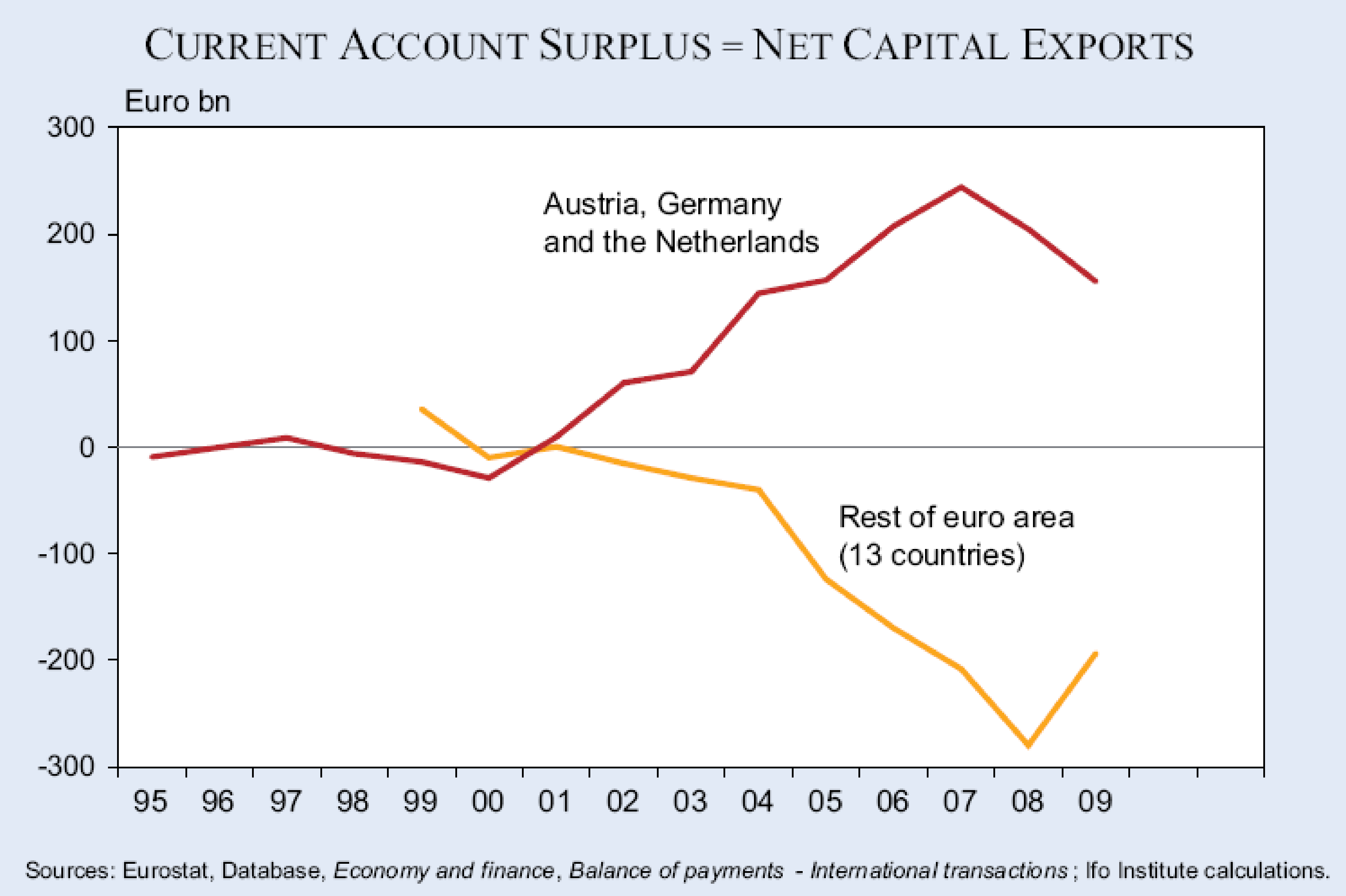
Note: There are no data for Malta. Malta was estimated for the calculation of the real devaluation.

Sources: Eurostat, Database, *Economy and Finance*, *National Accounts*; Federal Statistical Office, Special Series 7, Series 1, December 2009 (Wiesbaden 2010), table 2.1.1 and table 2.1.2; Ifo Institute calculations and estimates.

…contrary to current belief, ECB was not « conservative » but rather expansionist…

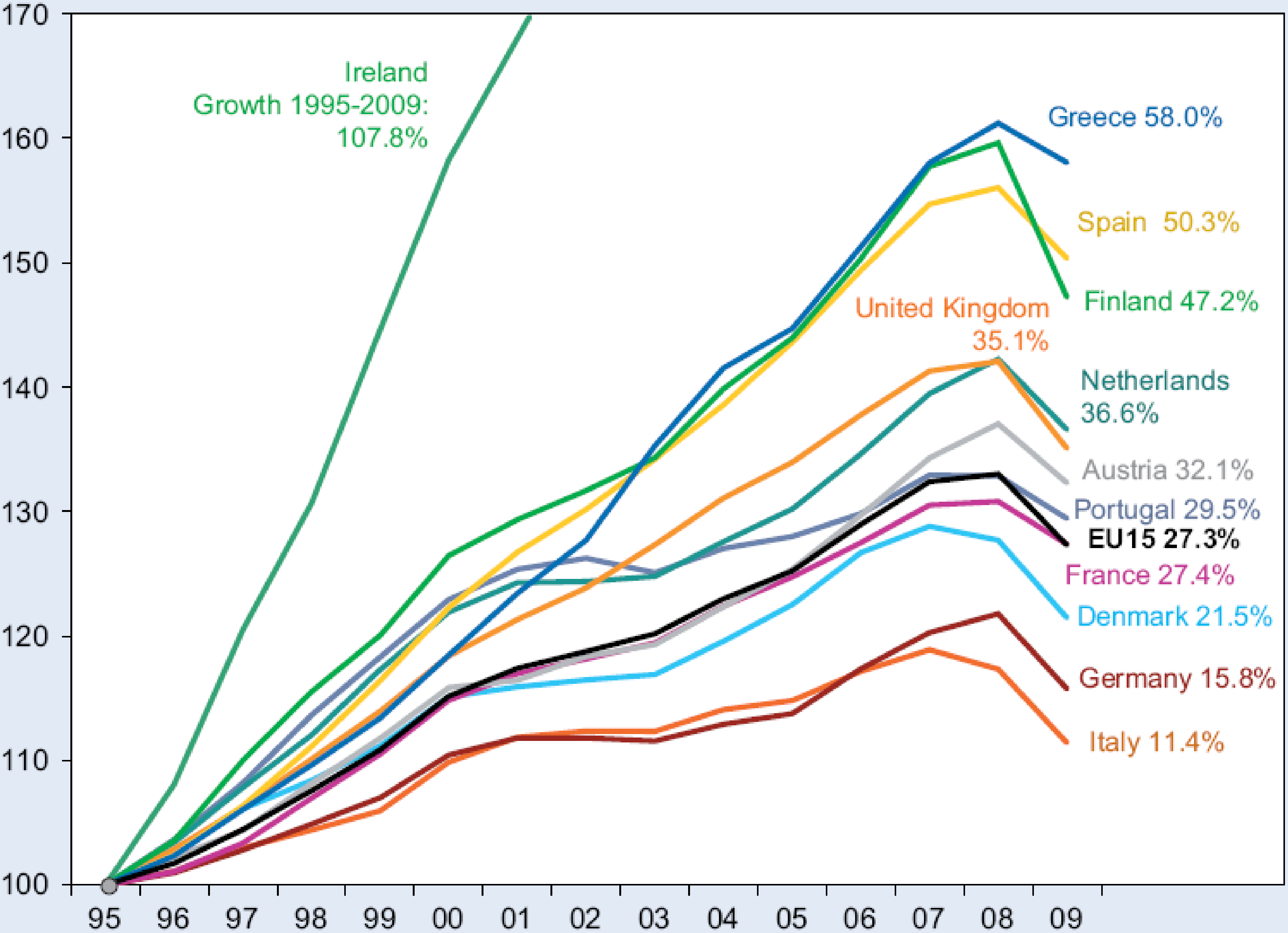


IFO source


CURRENT ACCOUNT SURPLUS = NET CAPITAL EXPORTS
Euro bn
300
200
100
0
-100
-200
-300
Austria, Germany
and the Netherlands
Rest of euro area
(13 countries)
95
96
97
98
99
00
01
02
03
04
05
06
07
08
09
Sources: Eurostat, Database, Economy and finance, Balance of payments - International transactions; Ifo Institute calculations.

Economic Growth in Selected EU Countries

Chain linked volumes at prices, 1995=100



Sources: Eurostat, Database, *Economy and Finance*, *National Accounts*; Ifo Institute calculations.

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ource

Competitiveness divergence in EMU (EC source)

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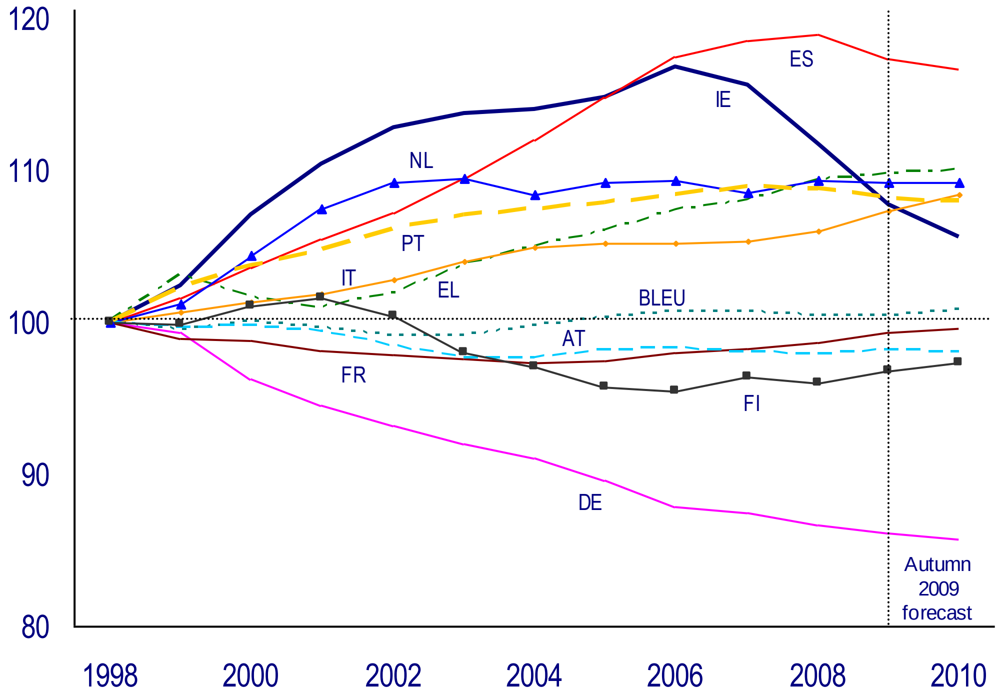
Intra euro area REER divergence
(1998-2010 - in %, based on GDP deflator)

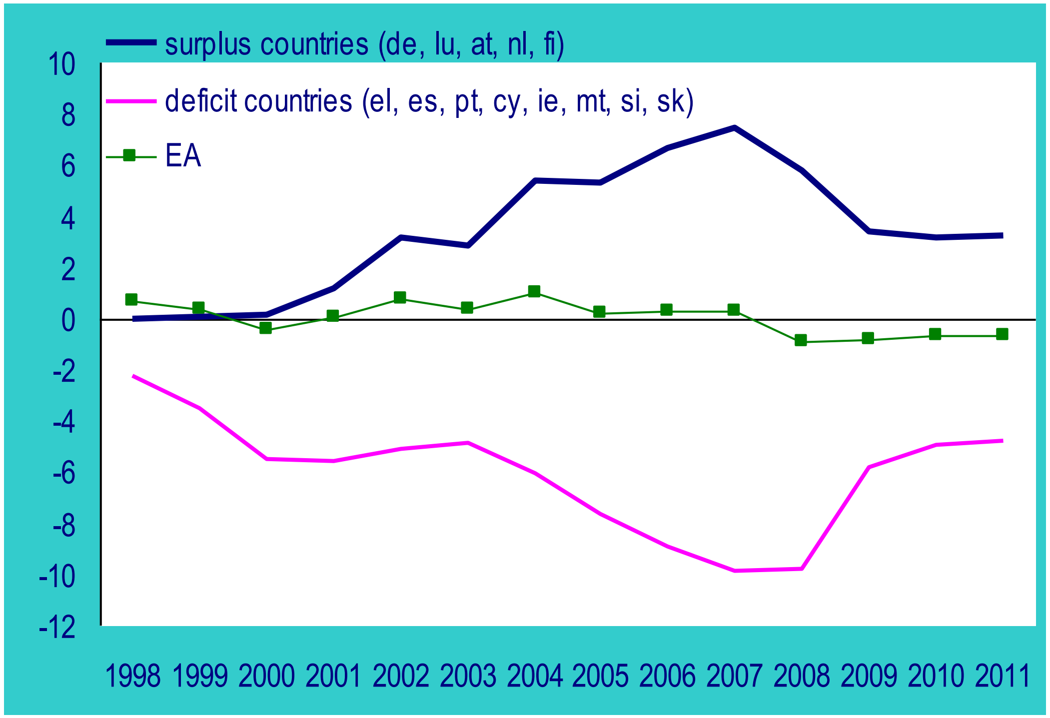


Persistent divergence in cost and price competitiveness – going hand in hand with divergence in export performance

Crisis impact: limited price adjustments, resulting in costly rise of unemployment in some Member States

Competitiveness divergence in EMU

Current account divergence as % of GDP



Significant divergence in current accounts: not bad per se

- catching-up growth
- consumption smoothing

However, persistent !!! Common concern for the functioning of EMU.

Crisis impact: crisis forces correction of current accounts and credit flows.
BUT, limited price adjustments result in a costly rise of unemployment in some Member States

Competitiveness divergence in EMU

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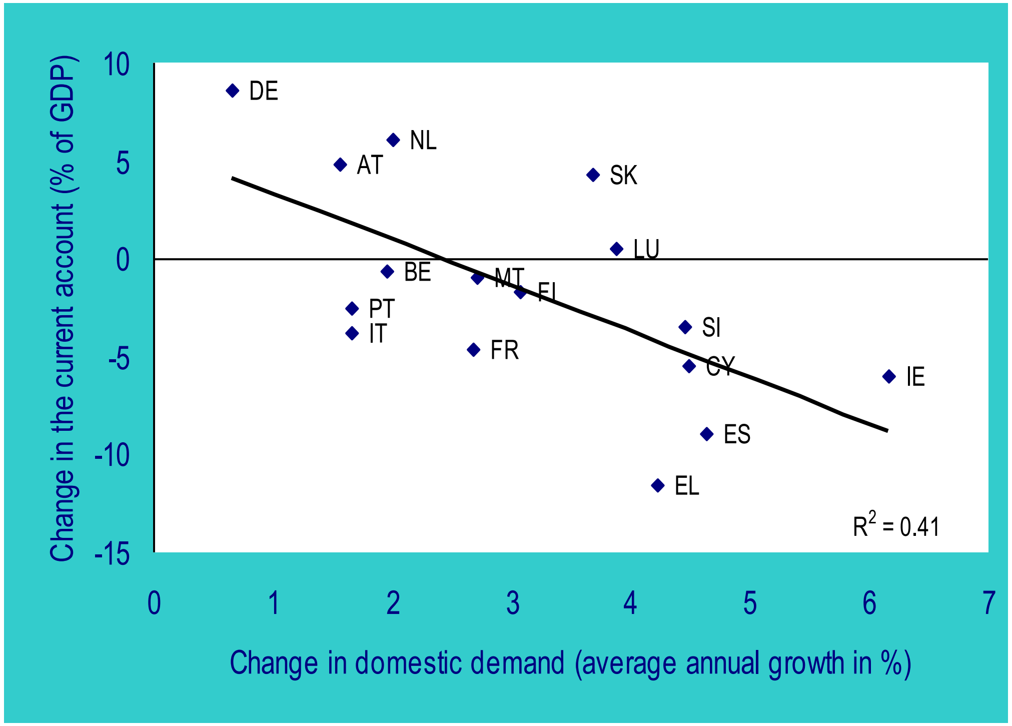
Domestic demand and the current account (1999-2007)



Differences in domestic demand are an important driver of the divergence in current account in the euro area

Strong relative demand in a Member State tends to fuel import demand and depresses current account

Competitiveness divergence in EMU
Underlying factors of concern

Domestic imbalances, in many Member States, drive the external divergence:

- ✓ House price overshooting – House market bubbles
- ✓ Private sector debt overshooting
- ✓ Little productive use of capital inflows (e.g. housing investment, consumption purposes)

Intra-area adjustments to external imbalances work slowly, are costly and have negative spill-over effects across Member States

Competitiveness divergence in EMU
Addressing the problems

Source of imbalances need to be identified,

- ✓ Market failure (e.g. bubbles) ?
- ✓ Policy failure ? E.g. insufficient fiscal consolidation in some MS
- ✓ Weak private sector demand in surplus countries (e.g. DE)

Post-crisis needs:

- ✓ Sectoral restructuring needs (e.g. away from overblown construction sector)
- ✓ Deleveraging of private sector
- ✓ Re-balanceing sources of growth in surplus countries

Overall, adjustment challenges in less benign post-crisis global economic environment :

- ✓ Wage/cost adjustment more difficult in overall low inflation/ potential growth environment
- ✓ Financial intermediation partly dysfunctional

4. Was the Maastricht architecture wrong?

Architecture was not perfect but was not wrong

- **Maastricht was insufficient but not wrong,** secondary legislations and policy consensus had to be built but were not...
- **Contrary to many present commentators**, the asymmetric logics was right and remains the only practicable one in Europe,
- **The Maastricht flaws were only** the too much political process controlling EU surveillance: a Council « judge & part », a "toothless", not-independent Commission, too vague Treaty.
- However the € logics is a "*trial-and-errors*" process, the Treaty call for enacting complementary legislation or Council decisions for correcting the loopholes and compensating for caveats: enforcement failed for lack of reactions not due to Maastricht architecture caveats but for lack of implementation

The Treaty was not applied and the SGP violated

It is not the Treaty itself and the EMU architecture which should be questioned but the way it has been applied until now

Main weaknesses: lack of broader surveillance exercises (not only fiscal but competitiveness and private governance), lack of market enforcement mechanisms, weak power biased by insufficient independence and bravery of Commission facing a Council which is "judge & part", absence of national ownership in an inexistent EU wide policy debate and a nationalistic recuperation of EU issues for domestic politics

The present lack of policy consensus backing the € is a result of misapplication, not a cause in itself

The **proof** relies upon the fact that the Treaty could not set other ultimate decision-maker than a "political" Council, but before to resort to it, some pragmatic devices should have been enacted

The Treaty was not applied and the SGP violated

It is true that lack of consensus is a serious threat for the €

But it would be even more stupid to declare as many: «*monetary union needs political union*»

This is a dangerous wrong overreaction:

It means either 1) «*let's go back to national currencies*» (re-segmentation of the single market, more instability with more national responsibility struggling at the expenses of cooperation. It should be easier to return to more national responsibility without more segmentation

or 2) «*let's create an €-economic government for countervailing the ECB*» (Sarkozy), a insufficient coordination or surveillance does not mean that national sovereignty would be bad or that the issue would be solved by controlling the ECB

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The present lack of policy consensus does not mean more centralization is required

To create an €-economic government is anticonstitutional, anti-Treaty and anti-democratic (EU level is not sufficiently transparent and backed by citizens) = «jacobin» threat for democracy! «Napoleonic governance» is condemned to fail in market economies

EU is not a federation, not even a genuine confederation

Even coordination could not legitimately impose fiscal discipline upon national Parliament wills (subsidiarity!)

Conclusion: improve Maastricht by making effective and broader policy surveillance through independent monitoring + market sanctions + national ownership through national rules/agency

5. What could be changed inside the Maastricht Treaty?

Solution is to strenghten governance not by centralistic decisions but by market incentives and national ownership

No need to change the Treaty, just secondary legislation

Only way is to build better mechanisms for enforcing right common discipline and market information, in a decentralized way but with a Community organization of transparent monitoring both o public and private governance

⇒ enhance financial-market discrimination between fiscal policies and competitiveness trends (i.e. market sanctions) in order to make national self-interest to coincide with the shared €-area interests

HOW? 1) create an independent monitoring body (DG ECFIN becoming independent but reliable to EP and economist community, making surveillance and issuing public recommendations => EP public hearings

Solution is to strenghten governance not by centralistic decisions but by market incentives and national ownership

2) Create financial-market discrimination between national €-bonds by creating by EU legislation (i) a "SGP-conform label" given by ECFIN to the issuance by MS respecting the SGP (ii) a subordination clause committing MS Treasury to warrant priority and full reimbursement to those SGP-conform bonds (+ EU guarantee also possible= €-bonds)

=> opening spreads against those MS not respecting fiscal discipline + providing a powerful mean for awarding adjustment efforts by extending "SGP-conformity" to MS respecting their Stability program + possibility to impose "haircut" to irresponsible creditors by warranting new Bonds and discriminating against old ones (solving the Greek crisis and preventing other crisis)

Solution is to strenghten governance not by centralistic decisions but by market incentives and national ownership

3) Once demonstrated the advantages and effectiveness of enhancing the financial-market discipline through the labeling/subordination clause, it would become easier to negotiate the creation of the option of genuine <u>single €-bond market for new national debts respecting the SGP</u>

=> Creation of an "**European Debt Office**" (EDP) issuing € bonds warranted by the EU for buying national € bonds when they respected the independent surveillance exercises (SGP conform), when MS slip away, monitoring market (liquidity advantages) EDP would charge progressive spreads on the already bought bonds = powerful instrument for automatic sanctions threatening any mismanagement = enhanced incentives for decentralized SGP enforcement + reserves

Solution is to strenghten governance not by centralistic decisions but by market incentives and national ownership

4) In addition, need for national legislations for ensuring national ownership through budgetary/wages rules and independent agencies for monitoring at national level in coordination with independent ECFIN/EU wide agency.

National legislation could be an alternative to a change in the Treaty: EU Council would decide that each euro-area member should enact its fiscal rule for ensuring the respect of the SGP.

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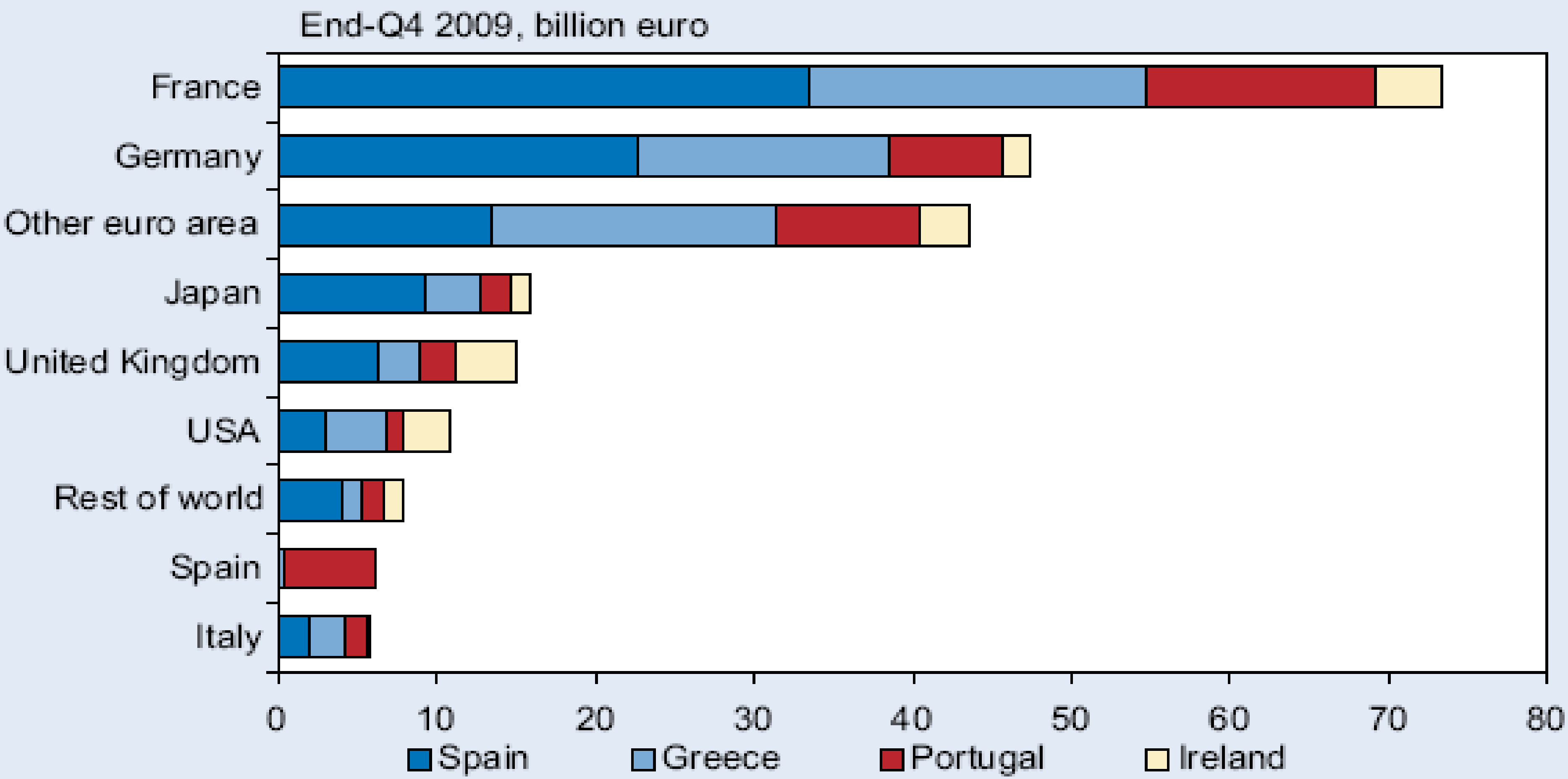
Claims of Foreign Banks on the Public Sectors of Spain, Greece, Portugal and Ireland



Source: Bank for International Settlements, *BIS Quarterly Review*, June 2010, p. 19, data on request.

The Greek Tragedy

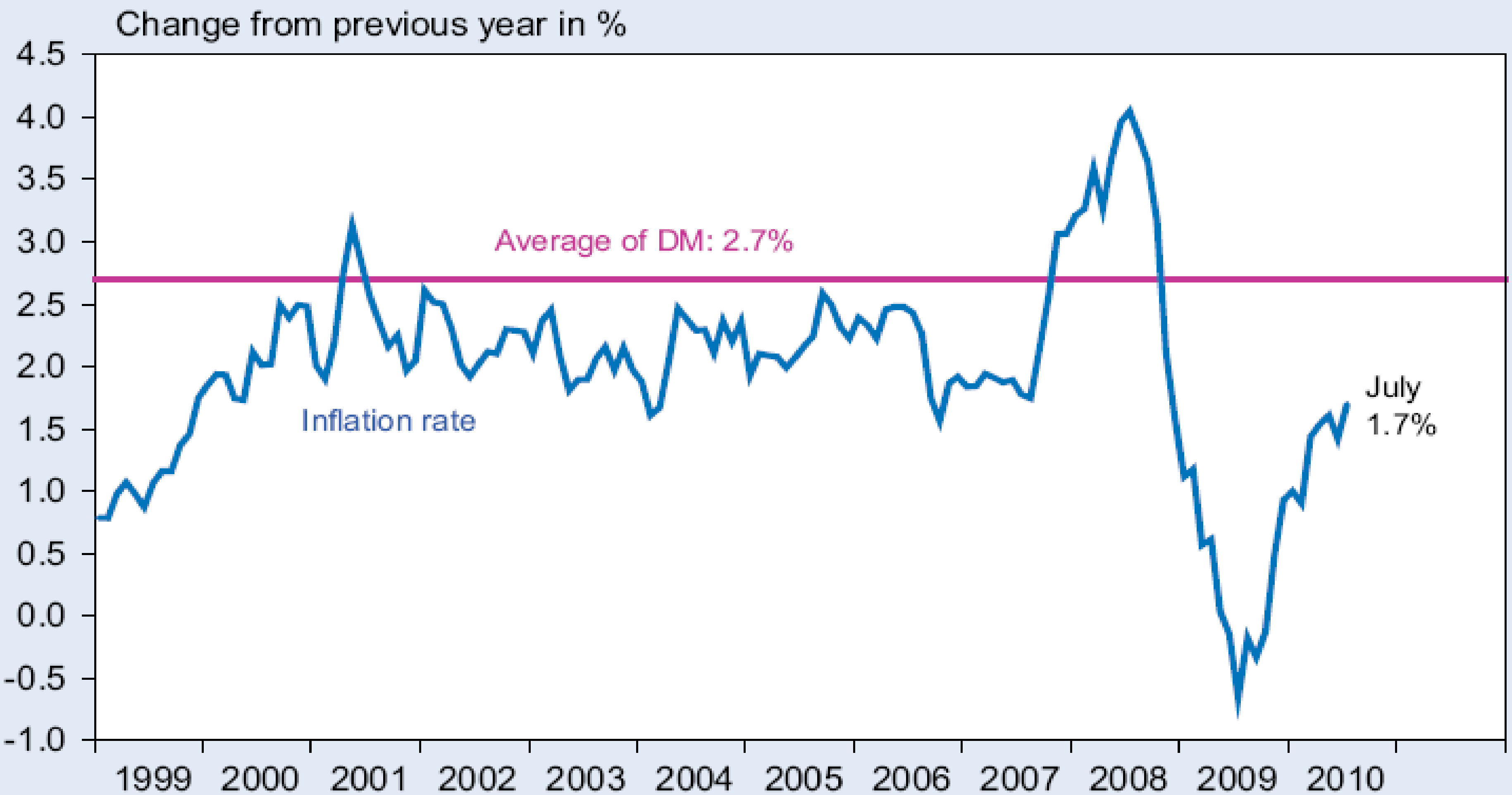
Table 1

The rescue packages and the liability limits (billion euro)

	All countries	Germany	France
European Financial Stability Facility (EFSF)	440	147.4	110.7
European Financial Stability Mechanism (EFSM, European Commission)	60	12.0	9.7
IMF euro rescue plan	250	14.9	12.3
EU rescue plan for Greece	80	22.3	16.8
IMF rescue plan for Greece	30	1.8	1.5
ECB purchases of government bonds (up to 30 July 2010)	60	16.4	12.3
Sum	920	214.9	163.3

Notes: Line 1: ECB capital shares (euro countries except Greece), increased by 20%. Line 2: 2008 shares in EU Budget. Line 3: Current IMF capital shares (5.98% for Germany and 4.94% for France). Line 4: ECB capital shares (euro countries without Greece). Line 5: as line 3. Line 6: ECB capital shares (euro countries).

Inflation in the Euro Area



Sources: Eurostat, Database Economy and Finance, *Prices*, 30 July 2010; Deutsche Bundesbank, Time Series Database, *Consumer Price Index*; Ifo Institute calculations.

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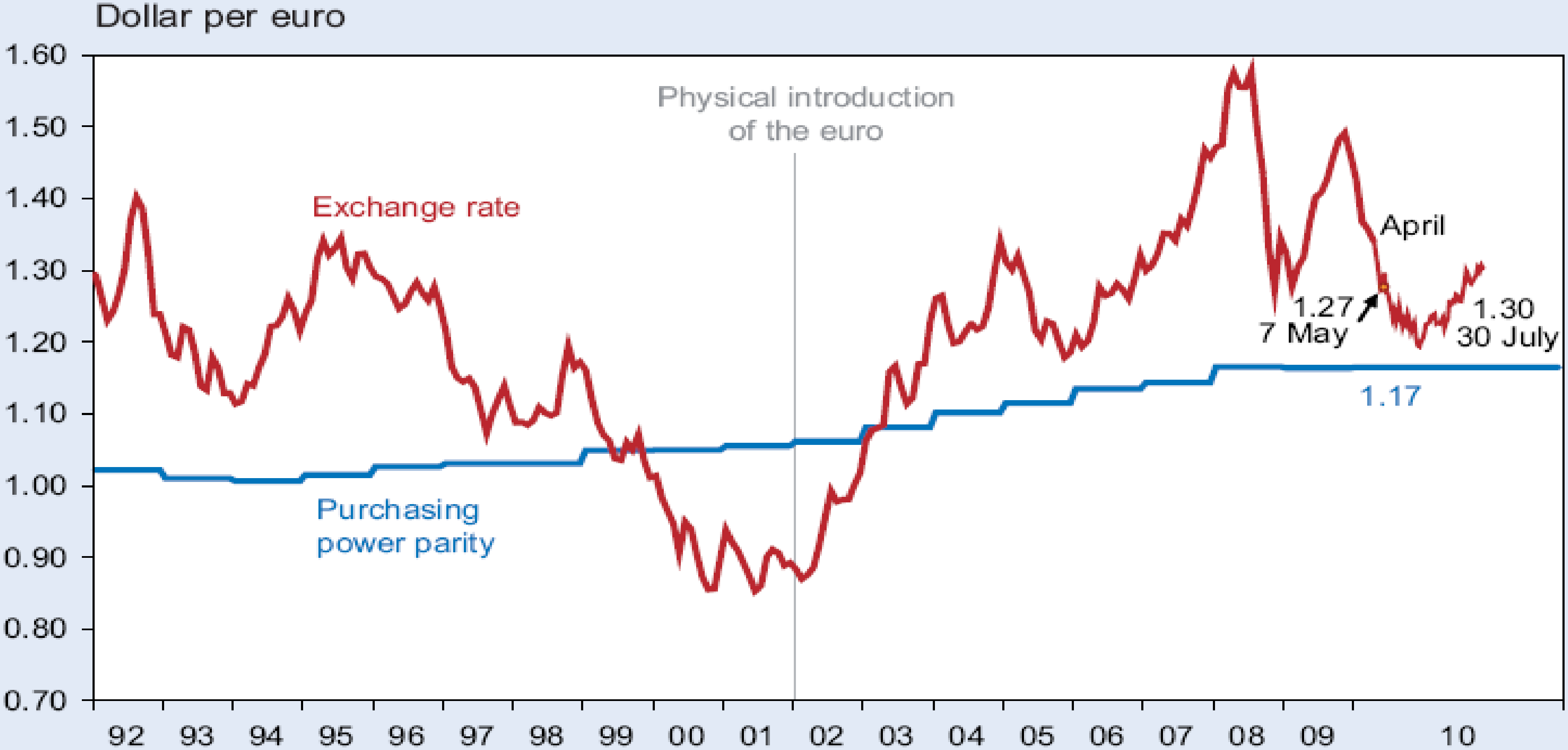
Exchange Rate of the Euro and Purchasing Power Parity

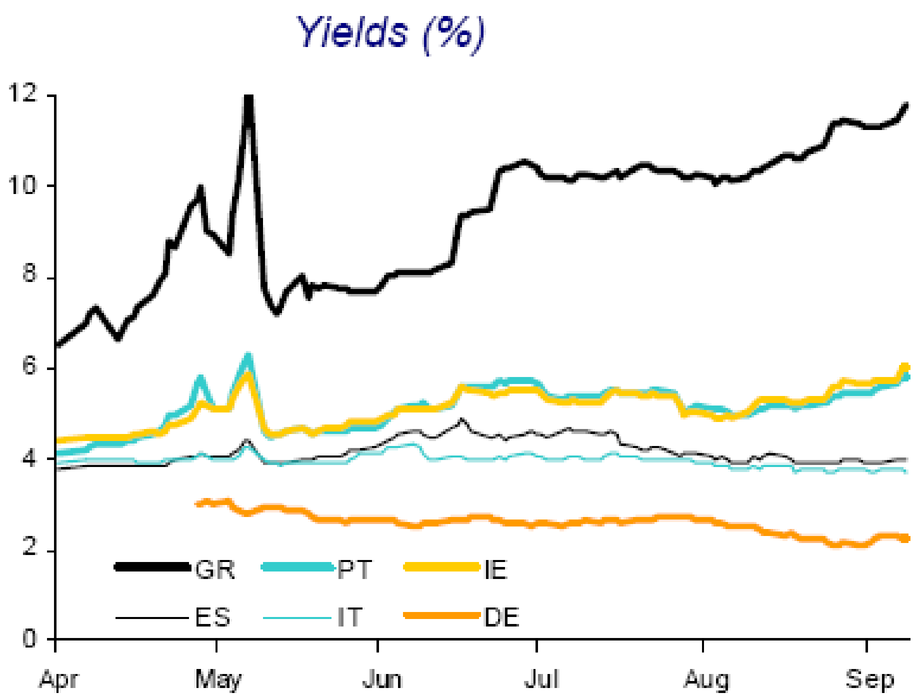


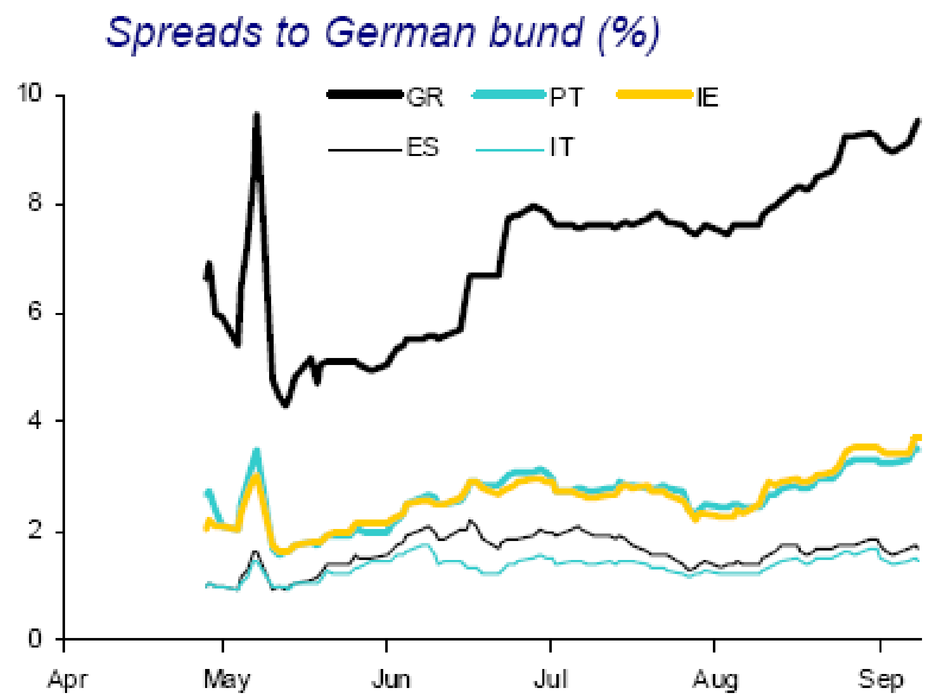
Notes: Before the introduction of the euro the graph shows the value of the deutschmark converted into euros at the official conversion rate. The time scale has been stretched from 1 May 2010 to be able to show daily data.

Sources: European Central Bank, Statistics, *Exchange Rates*, 30 July 2010; OECD, National Accounts Statistics, *PPPs and Exchange Rates*, 27 July 2010; Ifo Institute estimates.

Intra-€ Spreads

10 years government bonds





Source: Bloomberg and own calculations

(5-year) Credit Default Swap Spreads (Today's data)

United Kingdom 75
Japan 66
United States 47
Netherlands 47
Germany 42
Denmark 37
Sweden 36
Finland 28
160
140
120
100
80
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