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# The Euro Area: A Reality Check

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# Monetary Cooperation in Europe

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Four sub-periods in the evolution of monetary cooperation in the European Union.

First, the period from the collapse of the Bretton Woods system of fixed parities in 1973, to the emergence of the EMS in 1979.

Second, the period of operation of the EMS, until the creation of the euro in 1999.

Third, the first ten years of the euro area, before the crisis of 2009-2010.

Finally, the period since 2010, when the euro crisis broke out.

In each successive sub-period monetary integration was becoming gradually deeper, evolving from the “snake” of the 1970s, to the EMS of the 1980s, the tighter EMS of the 1990s, with infrequent realignments, and, eventually with the creation of the euro.



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# Macroeconomic and Financial Asymmetries

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All periods were characterized by significant macroeconomic and financial asymmetries among member states in the *core* and the *periphery*, but also by different degrees of monetary integration.

With the deepening of monetary cooperation, in the evolution from the snake to the euro, some of these asymmetries were addressed, while others were not.

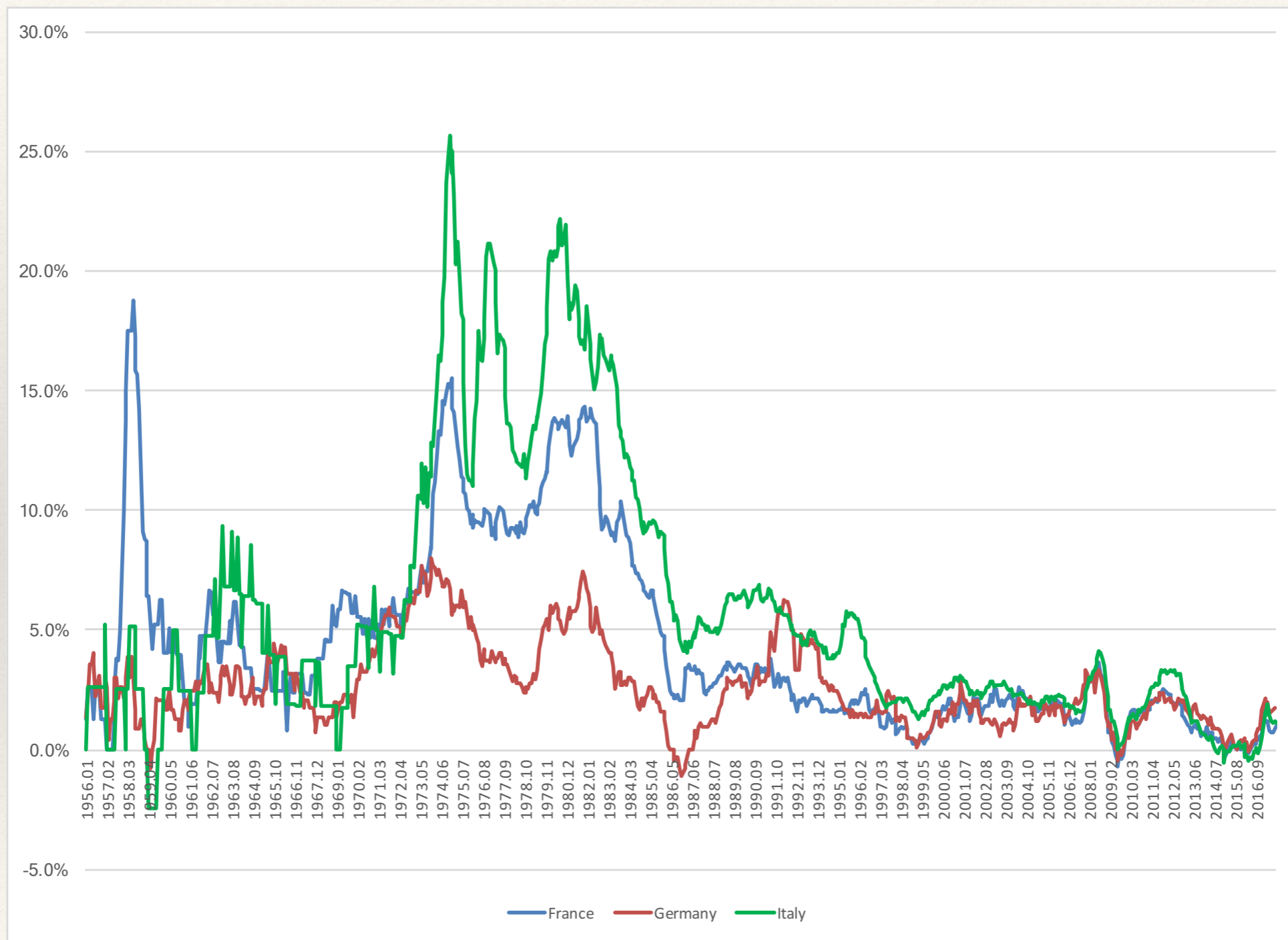
The main asymmetries addressed by the EMS and the Euro were nominal asymmetries, such as asymmetries in monetary policies and inflation rates.

However, when the euro was created, very little was done to address the remaining real and financial asymmetries, the loss of the tool of national monetary policies, and to introduce automatic stabilizers at the euro area level. The euro area essentially shifted the burden of adjustment to individual euro area members and their fiscal systems, as they lost their monetary sovereignty.

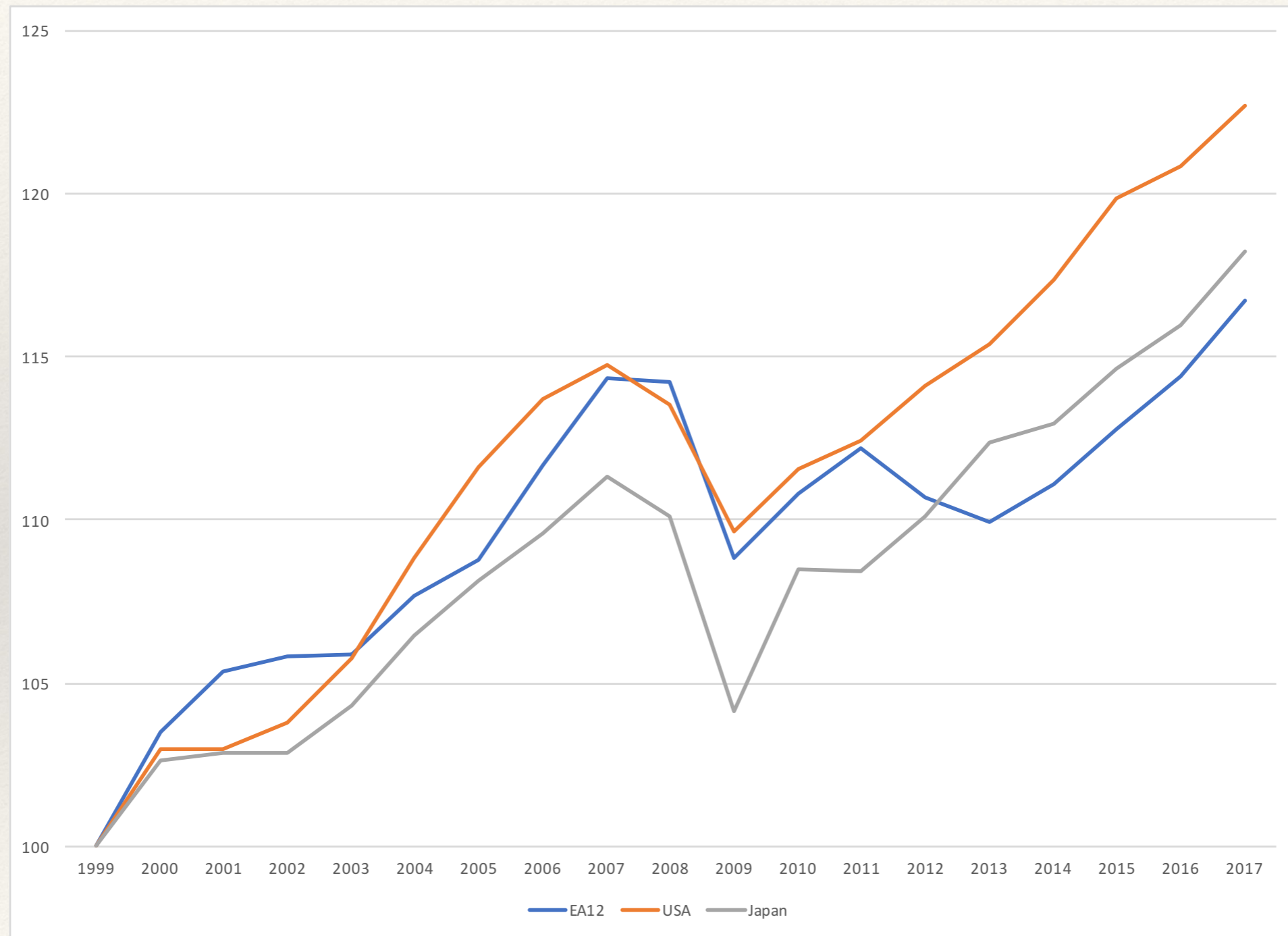
As a result, while nominal asymmetries, such as differences in inflation rates, and nominal interest rates were addressed by the creation of the euro, real, financial and external asymmetries widened, both before and after the euro area crisis.



# Inflation in Germany, France and Italy, 1956-2017

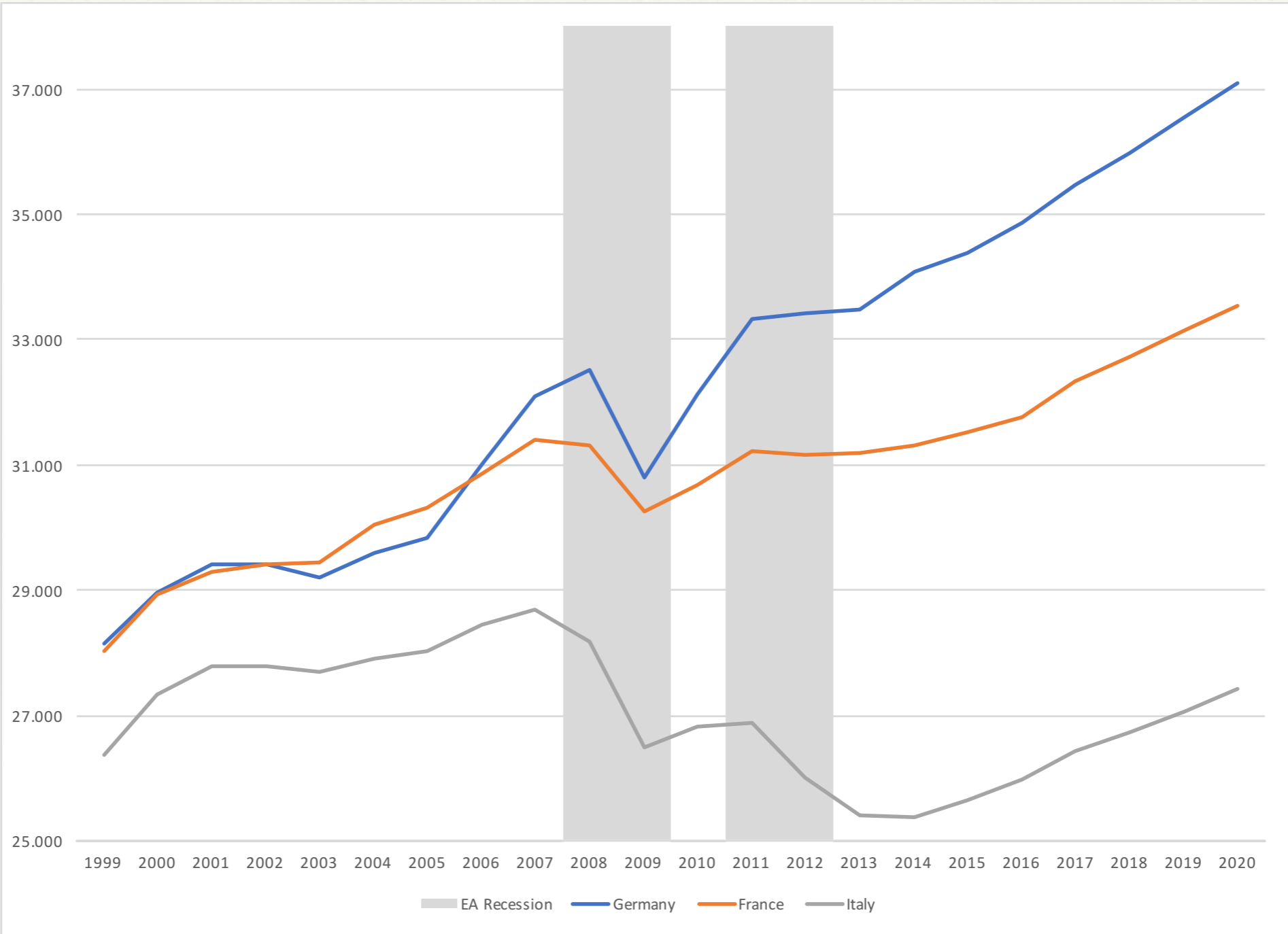


## Real GDP per Capita in the Euro Area, the USA and Japan since the Creation of the Euro (1999=100)





# Real GDP per capita in Germany, France and Italy since the Creation of the Euro (€ thousand at 2000 prices)





# Euro area 12: Core and Periphery

<b>Core (82.5%)</b>	<b>Periphery (17.5%)</b>
<b>Core Large (67.9%)</b>	
<b>Germany (28.3%)</b>	<b>Spain (11.1%)</b>
<b>France (20.1%)</b>	<b>Greece (2.5%)</b>
<b>Italy (19.5%)</b>	<b>Portugal (2.4%)</b>
	<b>Ireland (1.5%)</b>
<b>Core Small (14.6%)</b>	
<b>The Netherlands (6.0%)</b>	
<b>Belgium (3.6%)</b>	
<b>Austria (3.0%)</b>	
<b>Finland (1.7%)</b>	
<b>Luxembourg (0.3%)</b>	

**Source:** The weights are the ones used in the Area Wide Model (AWM) database of the European Central Bank. They are GDP based, adjusted for PPP, and reflect the PPP adjusted real GDP of each particular economy as a share of the Euro area economy GDP in 2001. See Fagan et al (2005) for more details.



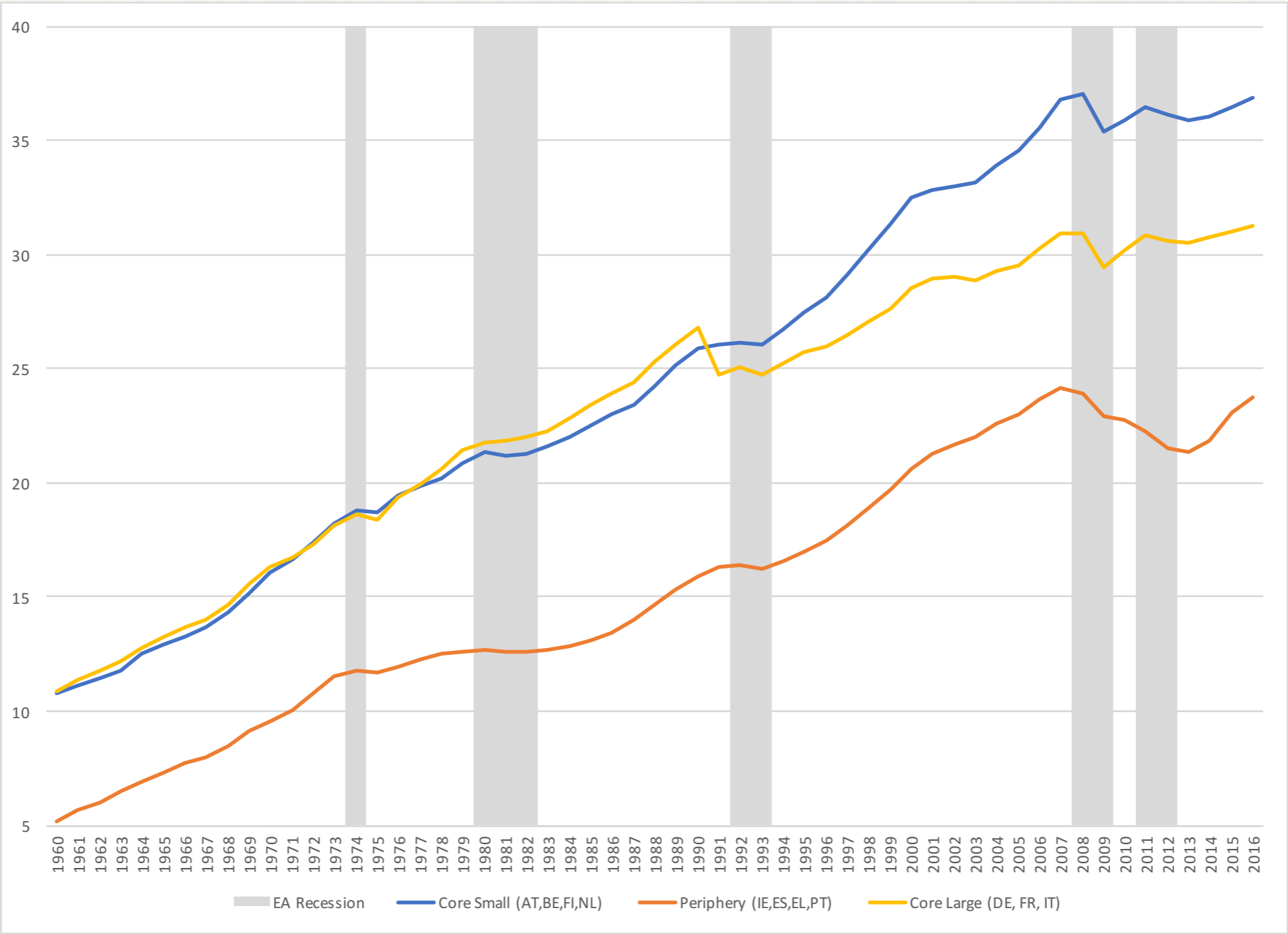
# Euro area 12: North and South

<b>North (64.5%)</b>	<b>South (35.5%)</b>
<b>Germany (28.3%)</b>	
<b>France (20.1%)</b>	
<b>The Netherlands (6.0%)</b>	<b>Italy (19.5%)</b>
<b>Belgium (3.6%)</b>	<b>Spain (11.1%)</b>
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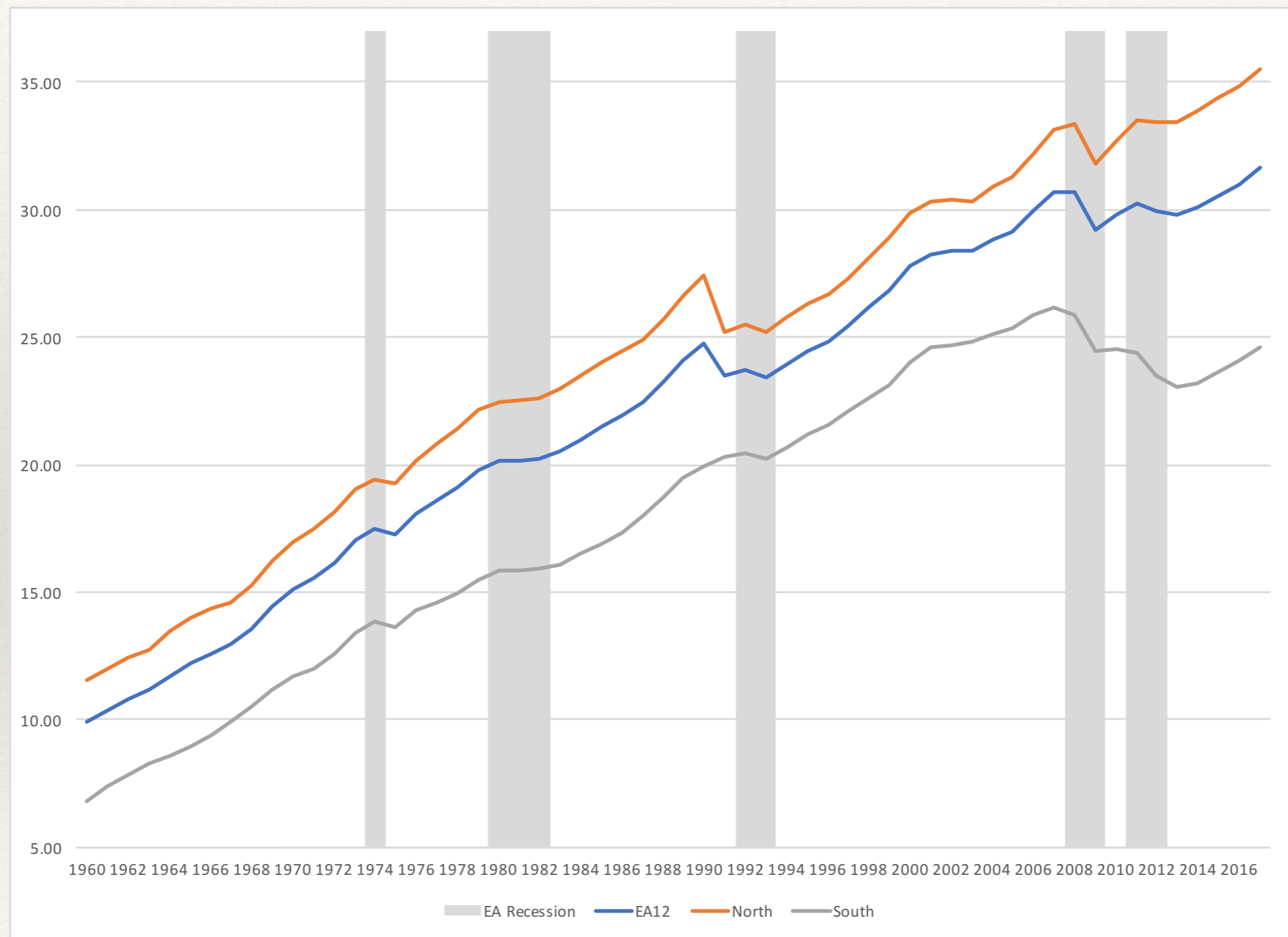


# GDP per Capita in the Euro area: Core vs Periphery (thousand € of 2010)



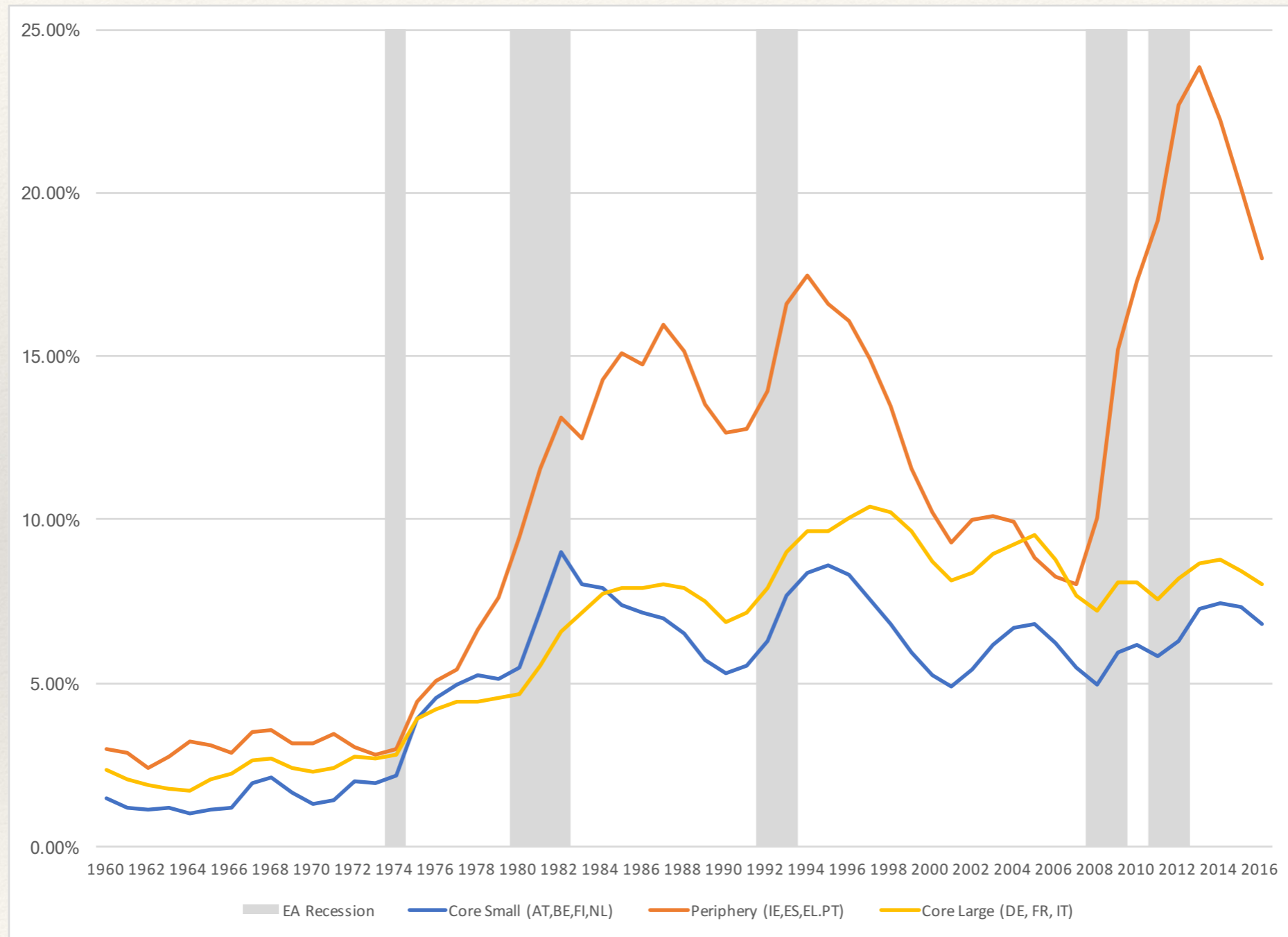


# GDP per Capita in the Euro area: North vs South (thousand € of 2010)



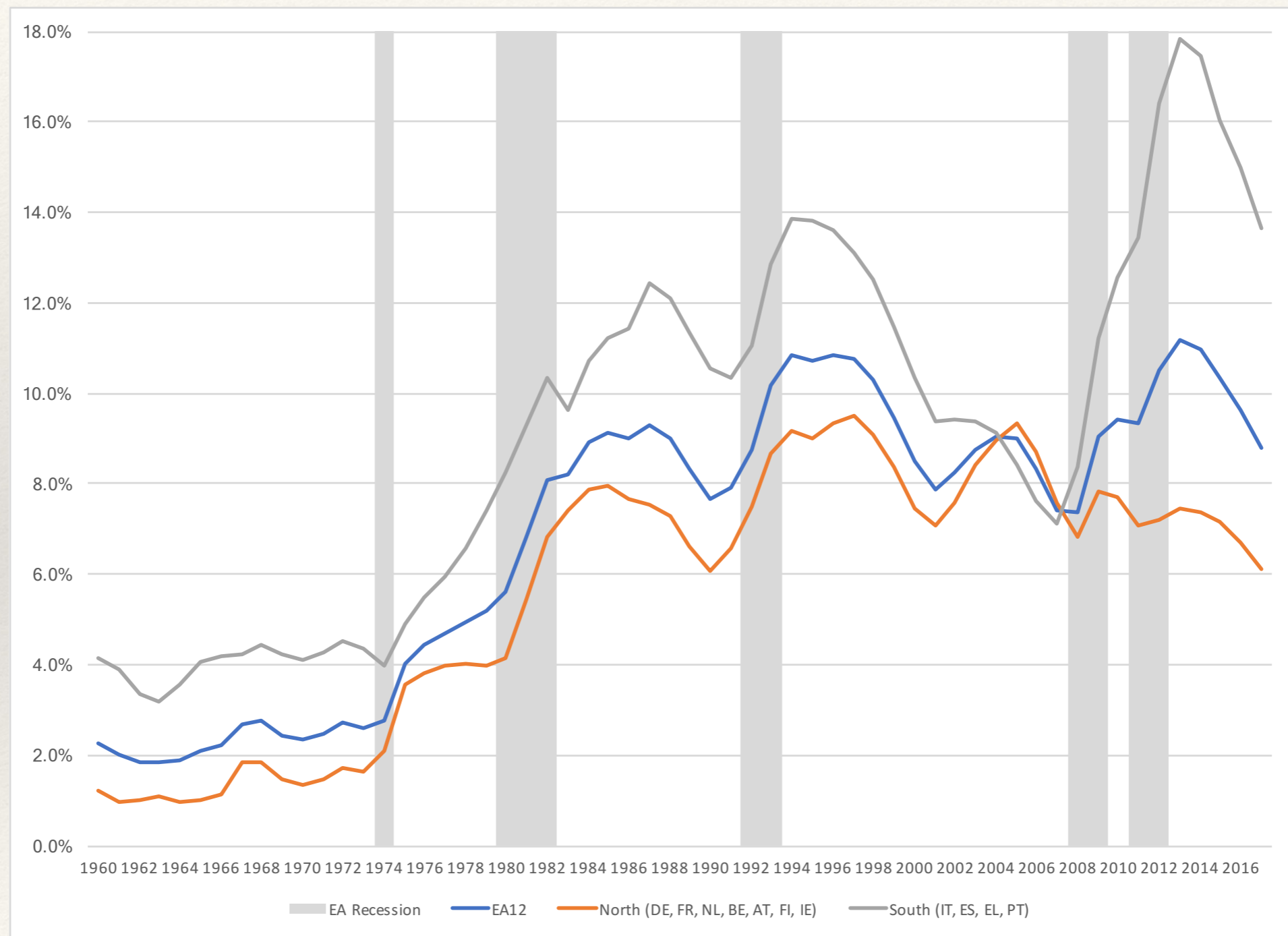


# Unemployment Rates in the Euro area: Core vs Periphery (% of the Civilian Labor Force)



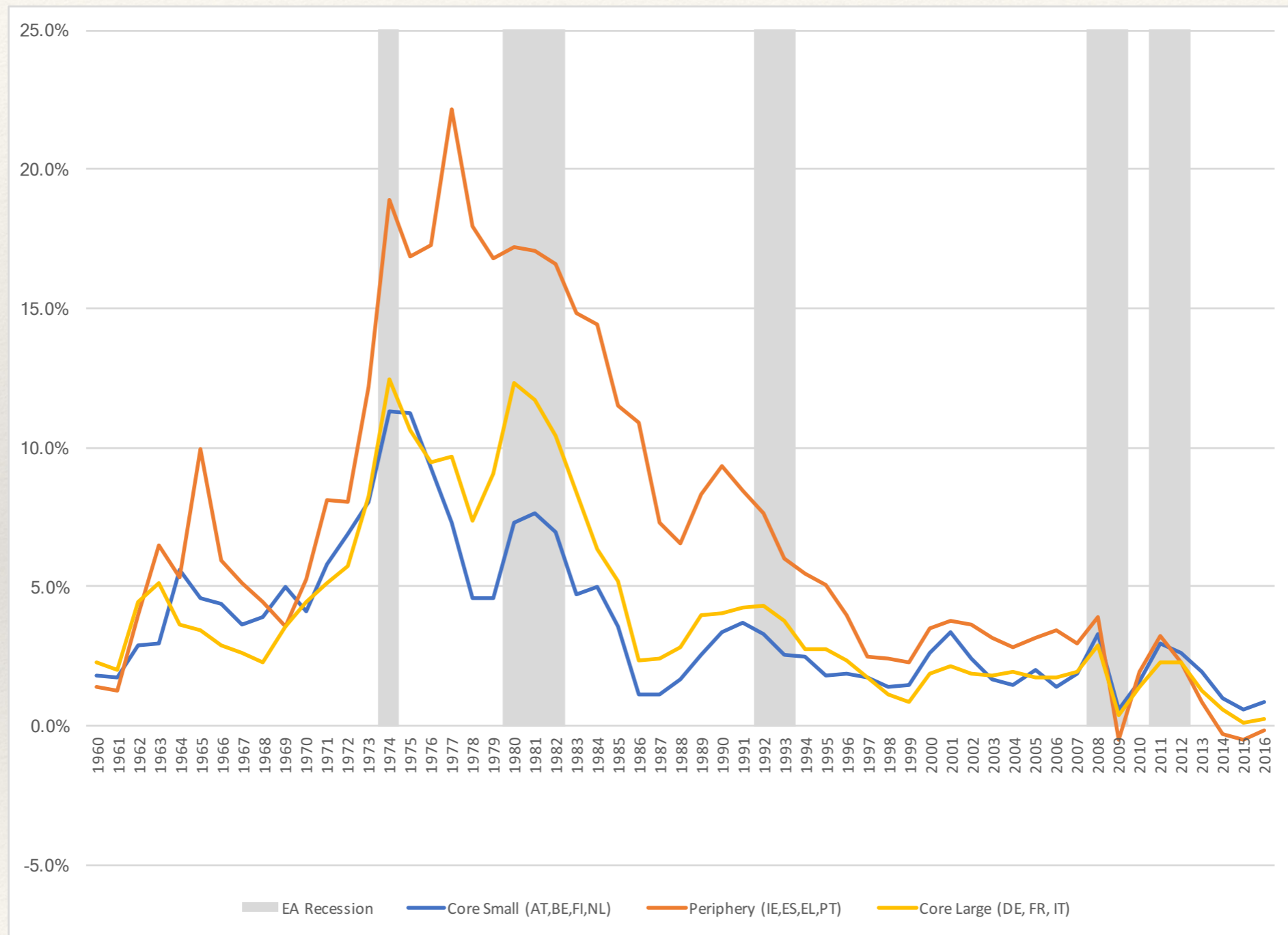


# Unemployment Rates in the Euro area: North vs South (% of the Civilian Labor Force)



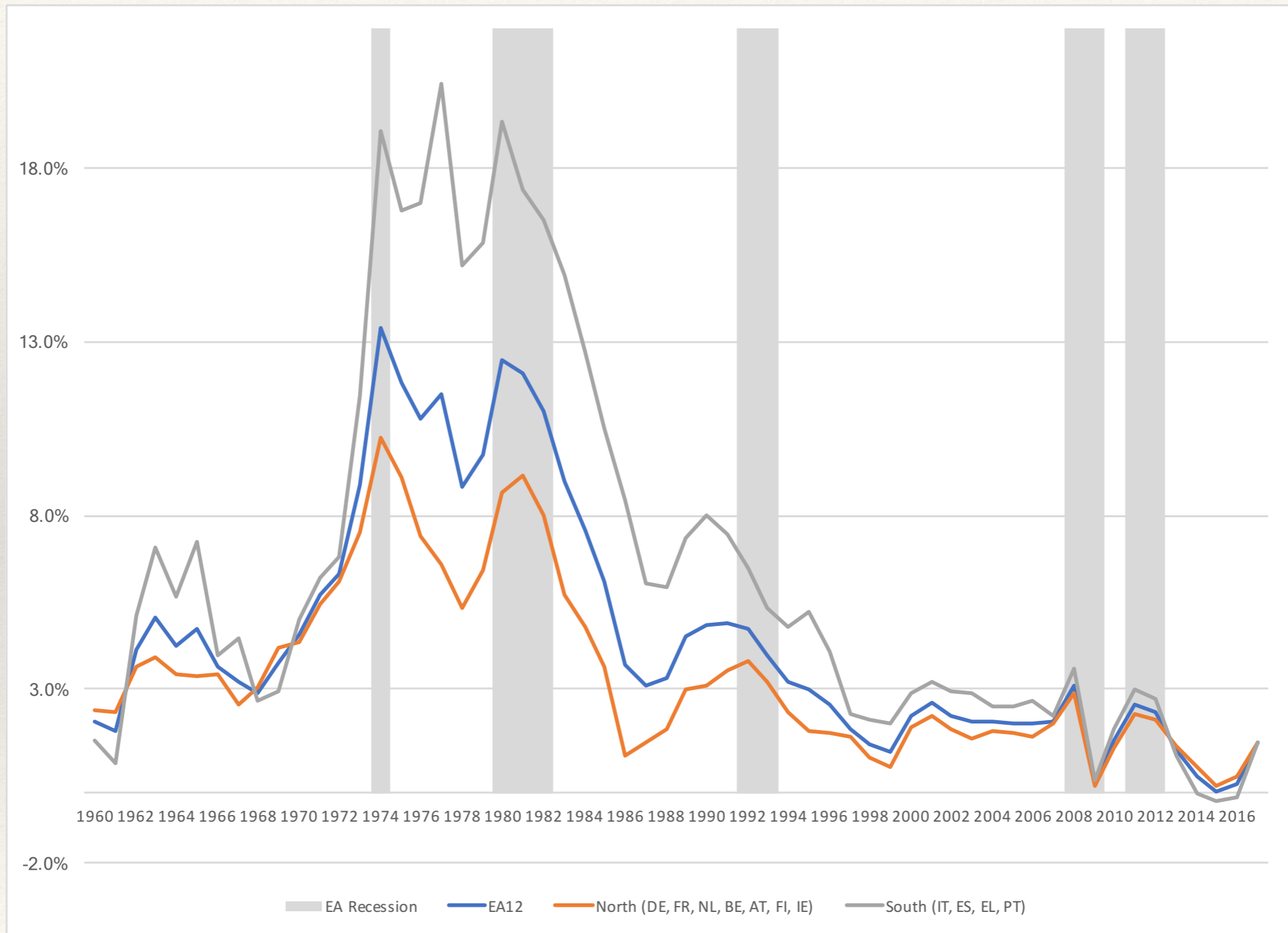


# Inflation Rates in the Euro area: Core vs Periphery (% per annum)



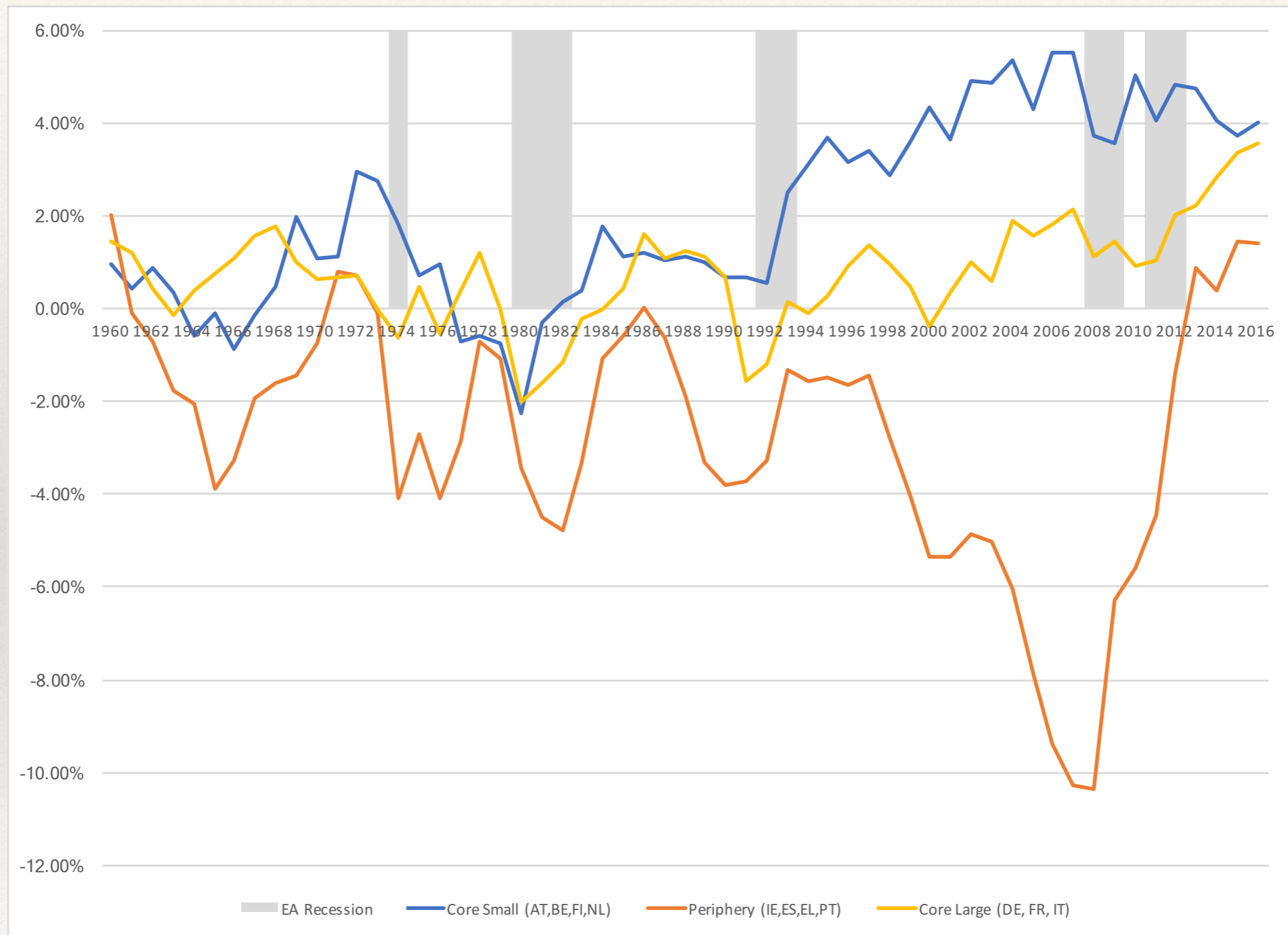


# Inflation Rates in the Euro area: North vs South (% per annum)



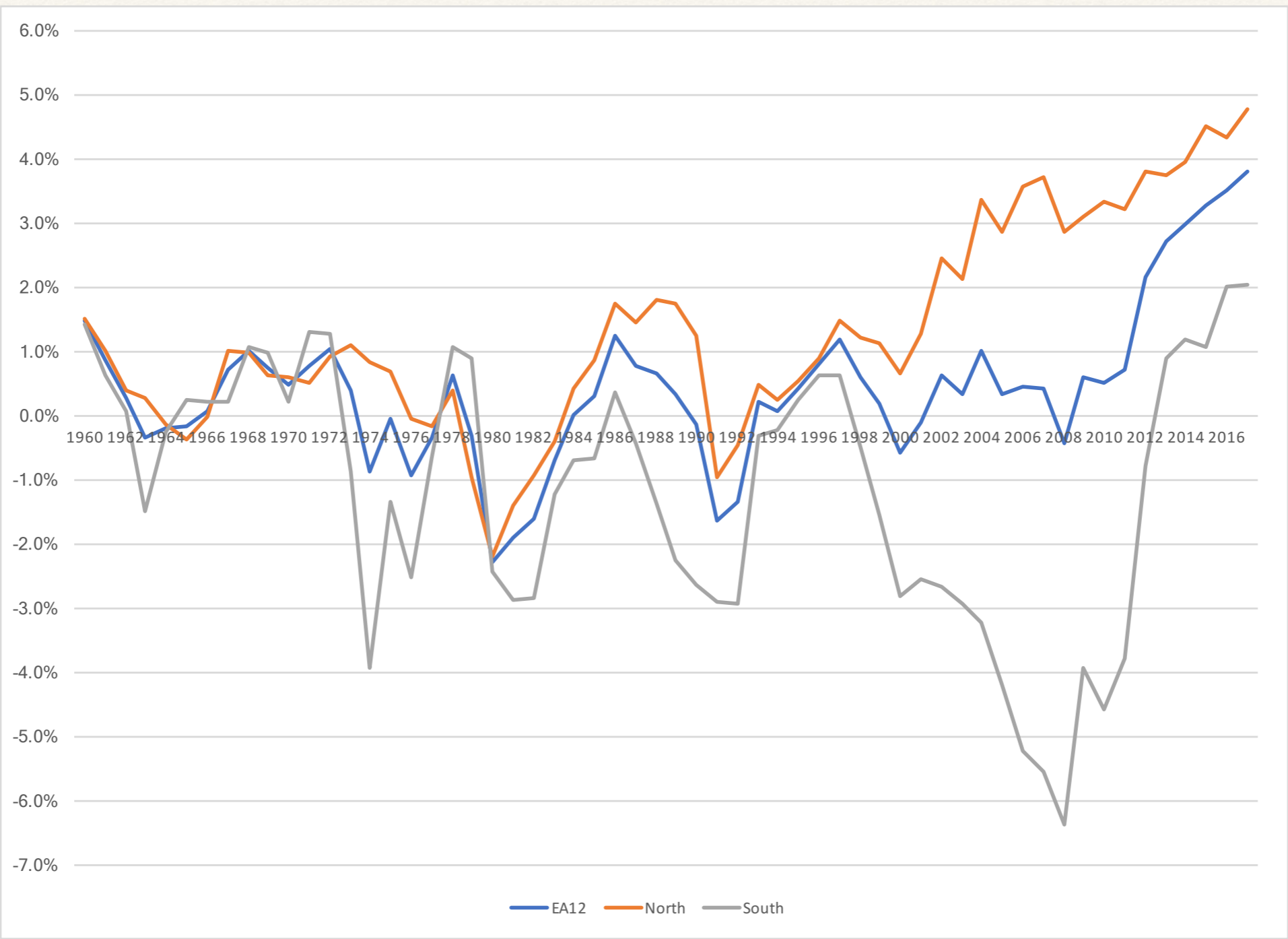


# Current Account Balances in the Euro area: Core vs Periphery (% of GDP)





# Current Account Balances in the Euro area: North vs South (% of GDP)





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# The First Ten Years: The Buildup to the Crisis

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In the first ten years since the creation of the euro, real asymmetries resulted in the build up of significant external imbalances, and, eventually contributed to the eruption of the euro area crisis.

The main financial asymmetric shock appears to have been the creation of the euro itself, which initially brought about the convergence of nominal and real interest rates between the periphery and the core. This convergence resulted in a widening of savings and investment imbalances in the periphery, which up until then had relatively high nominal and real interest rates.

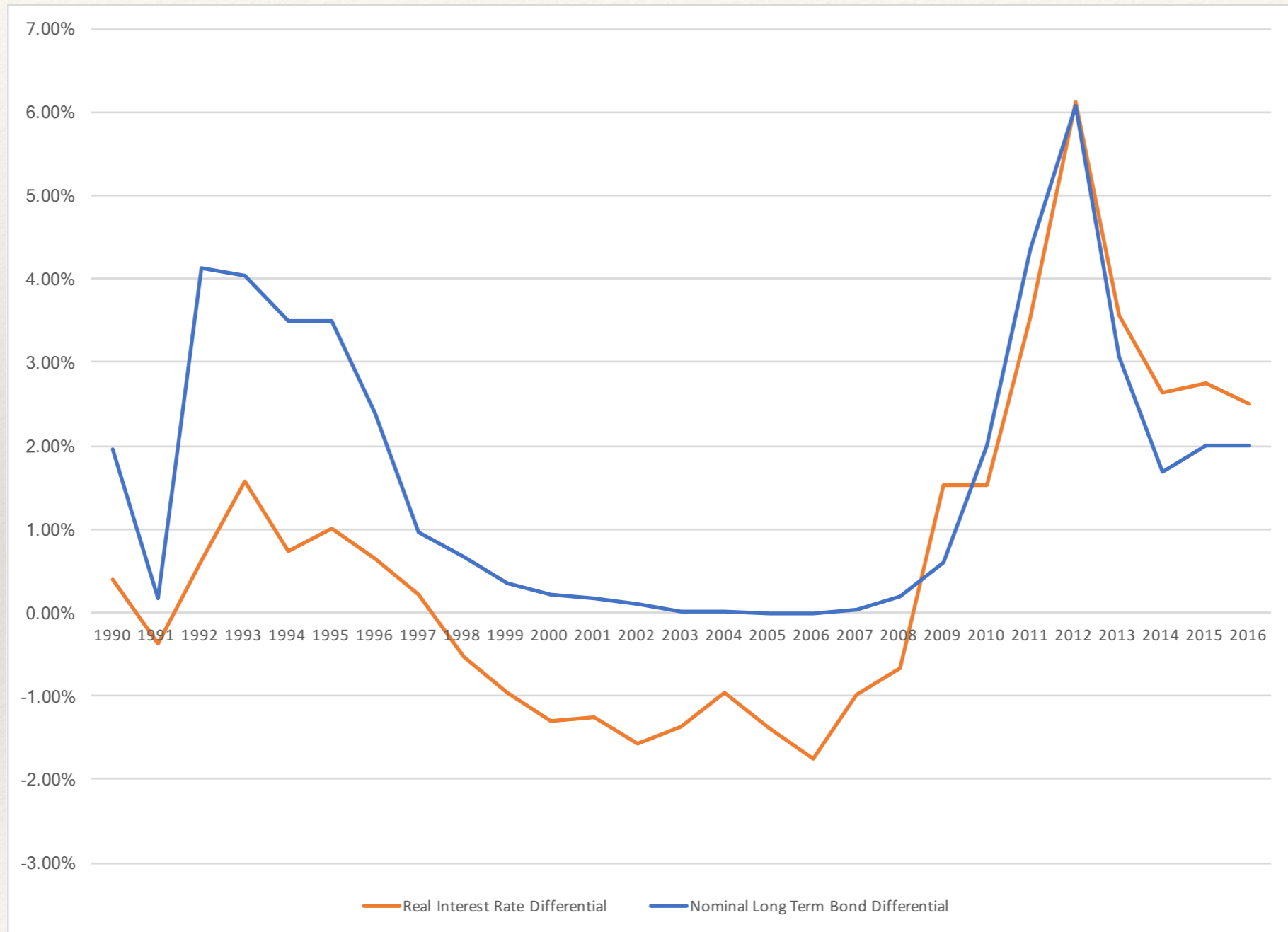
The convergence of interest rates brought about the widening of external imbalances, the buildup of external debt by the countries of the periphery, and eventually a euro area financial crisis.

This process was exacerbated by the “home” bias of banks in the countries of the euro area, due to the fact that the euro area was not a banking union.

The euro area crisis was essentially an external debt crisis in an economic and monetary union with a single currency, but major economic and governance problem areas. As a result, the euro area crisis of the 2010s was, at the end of the day, no different than other regional financial crises involving indebted economies, such as the Latin American crisis of the 1980s and the Asian crisis of the 1990s.

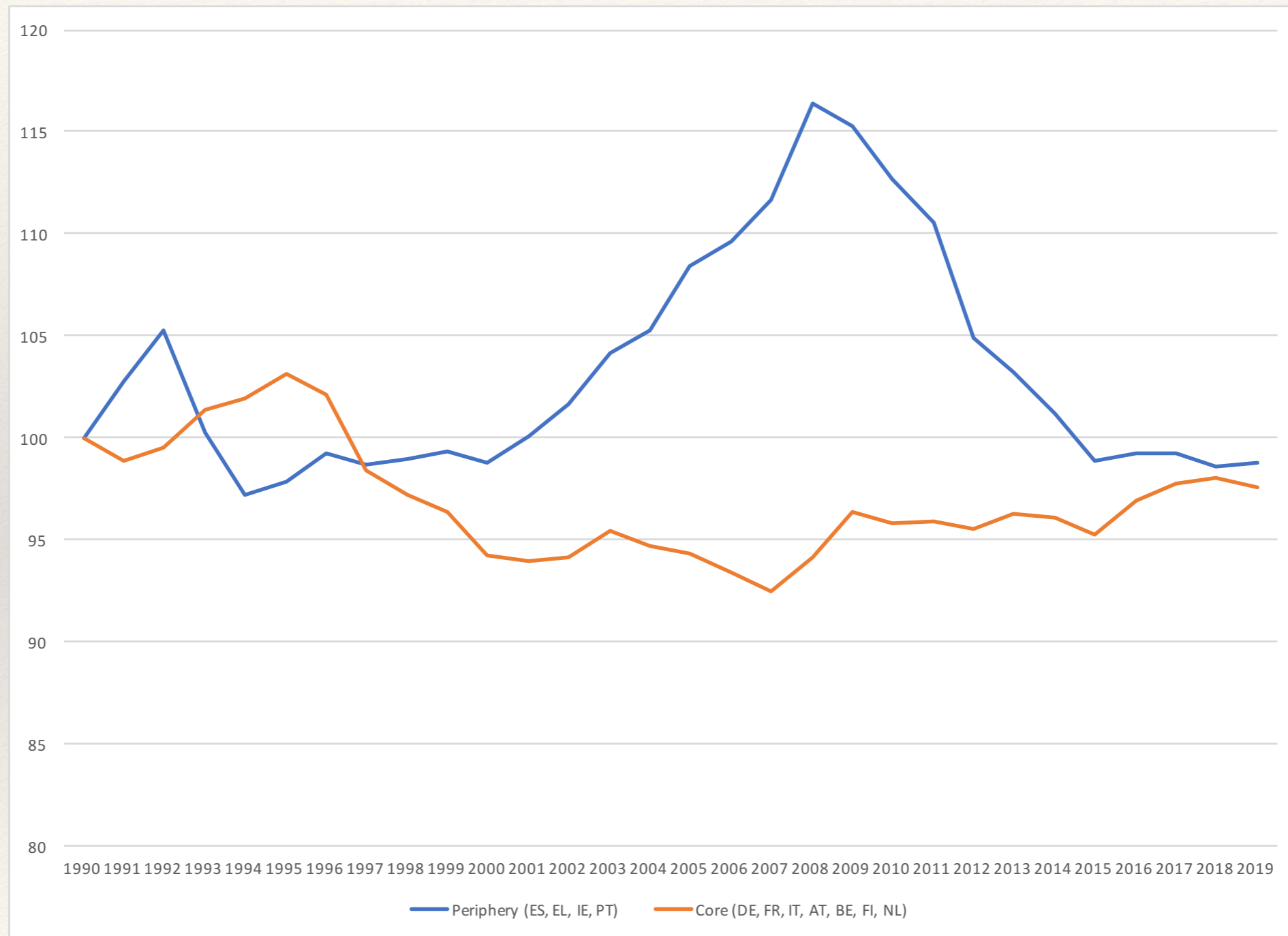


# 10 year Bond Rate Differentials between Periphery and Core



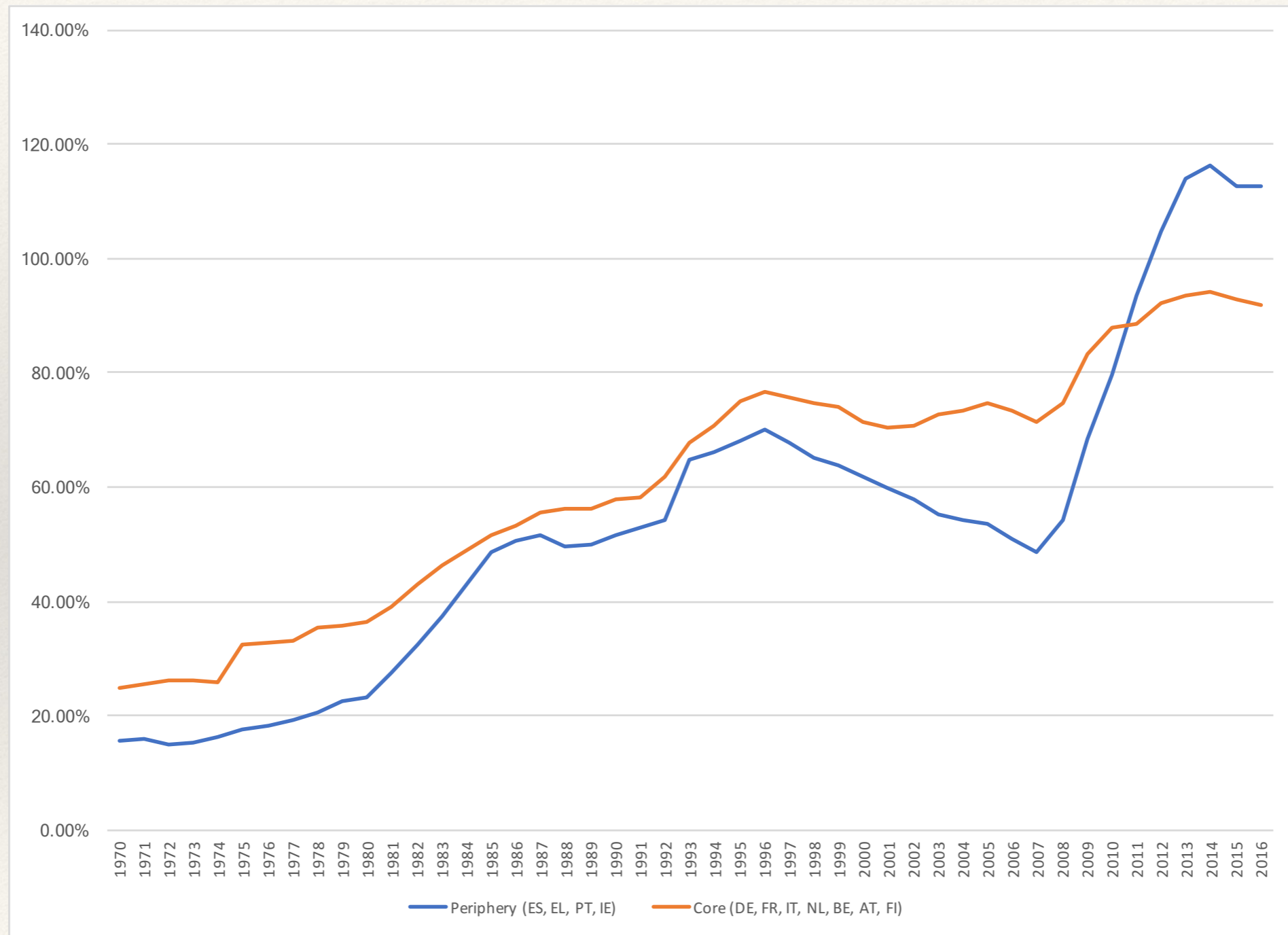


# Real Effective Exchange Rates in the Periphery and the Core 1990=100



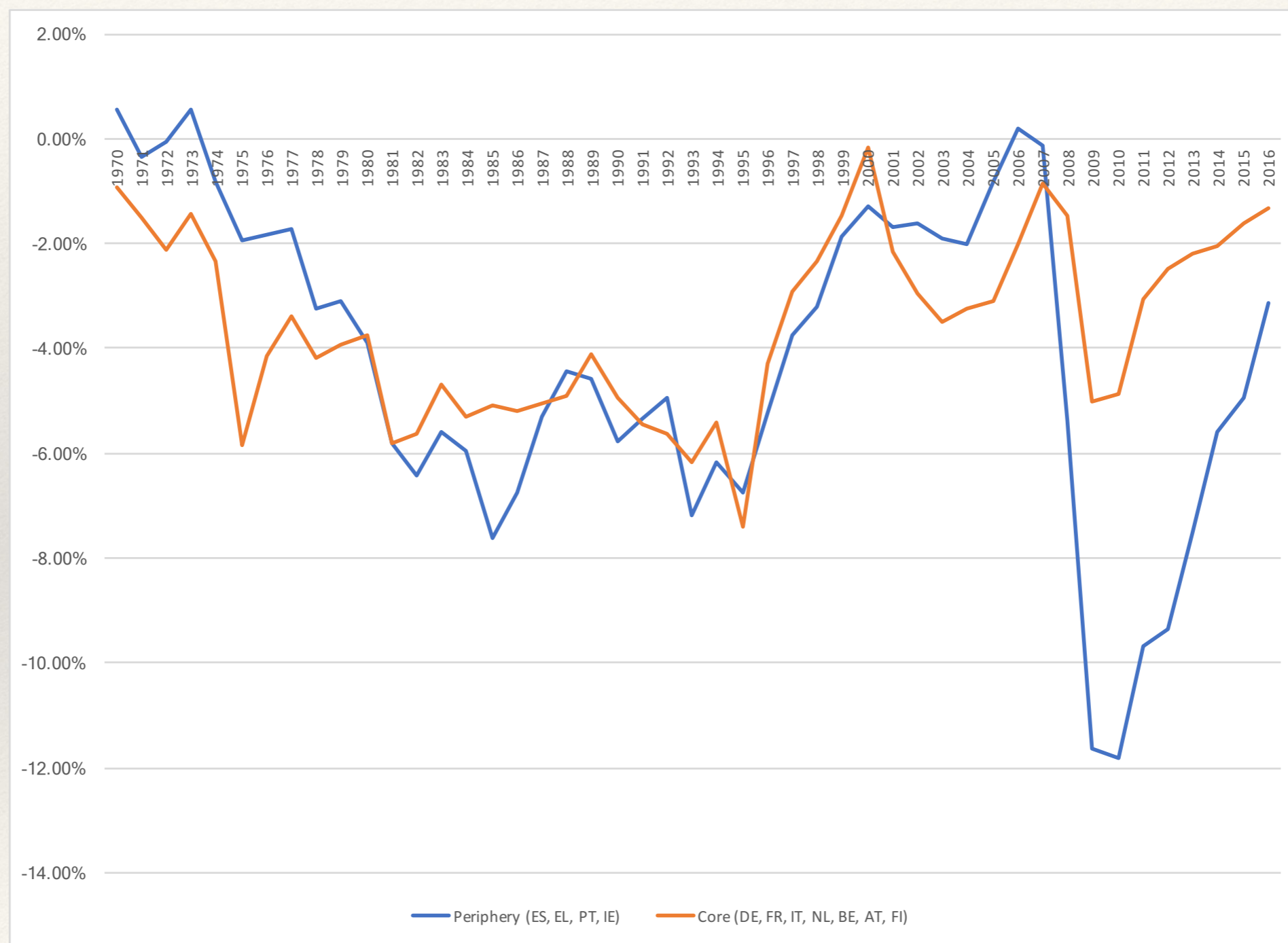


# Government Debt in the Periphery and the Core % of GDP





# Government Fiscal Balance in the Periphery and the Core % of GDP





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# The Euro Area Crisis

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The proximate cause of the EA crisis was the rapid unwinding of EA lending/ borrowing imbalances between the periphery and the core that built up in the 2000s. Some of this lending was to private borrowers (especially in Ireland and Spain) and some of it to public borrowers (especially in Greece and Portugal), but at the end of the day debt ended up in the accounts of governments, because of bank bailouts.

Often private over-indebtedness ends up on governments' balance sheets, so that the rise in public debt is more a consequence than a cause of a financial crisis.

The 'sudden stop' in lending led to sovereign crises, since EA members with current account deficits could not devalue, and the ECB could not bail out the governments of the periphery, because of the no bailout clause.

A confidence crisis thus ensued, first engulfing the countries of the periphery, but later affecting some of the core countries, such as Italy. The question marks were about the ability of various countries to service their public and private external debts. This was exacerbated by the initially unsuccessful EA efforts to address the debt problem in the periphery.



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# Deeper Causes of the Crisis

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The proximate causes of the crisis – imbalances and lack of crisis management mechanisms – tell us that there are really three sorts of underlying causes:

1. Design and policy failures that allowed the imbalances to develop and get so large
2. Lack of institutions to absorb shocks at the EA level
3. Crisis mismanagement

Some of these failures involved unanticipated events. Others were systemic and others were due to a failure to implement the provisions of the treaties.



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# The Fundamental Systemic Weaknesses of the Euro Area

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The major systemic problem areas appear to have been:

1. Major differences in the product mix between the economies of the core and the periphery
2. Fragmented national labor markets and low cross border labor mobility
3. Widely different fiscal systems, imperfect financial integration and lack of effective cross border financial regulation.
4. Extremely low federal budget that could not act as an automatic stabilizer through transfers from booming economies to economies suffering from recession
5. Lack of a lender of last resort to banks and sovereign governments at times of crisis, because of the no bailout clause of the ECB.

A result of the major asymmetries and other economic and governance problems of the euro area is the fact that adjustment efforts since the crisis have shifted the burden almost exclusively towards the weaker economies in the periphery of the euro area, which suffered deep recessions, a significant rise in unemployment, continuous tax rises and exorbitant social costs for young workers and old age pensioners, and rises in government debt to GDP ratios.



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# Optimum Currency Area Considerations?

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In retrospect, these developments were not surprising. The Euro Area did not satisfy any of the criteria suggested by the optimum currency area literature.

It does not satisfy the main criterion, namely the absence of asymmetries and asymmetric shocks between the periphery and the core.

Furthermore, it does not satisfy the other two main criteria for macroeconomic stabilization, namely integrated labor markets and a sufficiently large common budget that would act as an automatic stabilizer in the case of asymmetric macroeconomic developments.

Finally, its response to major financial crises is hampered by the lack of an effective lender of last resort, due to the no bailout clause for the ECB. The hasty creation of the European Stability Mechanism (ESM) did not and could not be a good enough substitute, as it lacks the firepower of a central bank in terms of resources.



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# The EA and the USA as Optimum Currency Areas

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The United States is much closer to the optimum currency area criteria than the euro area (O' Rourke and Taylor , *Journal of Economic Perspectives*, 2013).

1. **Market Integration:** US product markets are much more closely integrated than EA markets. Cross border inter-state trade amounts to 66% of US GDP, whereas cross border inter-country trade amounts to only 17% of EA GDP.
2. **Asymmetric Impact of Shocks:** No major differences between the US and the EA. The average correlation coefficient of GDP growth rates across US states is 0.46 and across EA countries it is 0.50. Macroeconomic asymmetries seem to impact the EA and the US in roughly the same degree.
3. **Cross Border Labor Mobility:** Major differences. The average share of people in a US state born outside that state is 42%, while the equivalent share in a EA country is only 14%. On the basis of this criterion, labor mobility is four times larger in the USA than in the EA.
4. **Fiscal Federalism and Automatic Fiscal Stabilizers:** Major differences. In the US about 30% of a state income shock is offset through federal fiscal transfers. In the EA, the relevant percentage is only 0.5%. The low level of the EA federal budget relative to the US has major implications for the ability of the EA to address shocks with an asymmetric impact.
5. **Lender of Last Resort:** Major differences. No bailout clause for the ECB, not such clause for the Fed. In fact, bank bailouts through borrowing from the Fed played a major role in addressing the 2007-09 crisis in the US.



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# Necessary Reforms for the Euro Area

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The euro area is in urgent need for additional fiscal, financial and labor market reforms. So far reforms have only be proposed at the national level. Yet, reforms at the Euro Area level are also clearly required.

A moderate and appropriately targeted increase in the EU budget would help smooth out the asymmetric impact of macroeconomic shocks through the operation of automatic fiscal stabilizers. It would also help countries in recession face fewer fiscal and financial consequences of such recessions at the national level, and would also partly address labor market fragmentation.

For example, a significant part of the fragmentation of labor markets in Europe is the result of the lack of a cross border system of unemployment and health insurance. This could be addressed in a reform that would allow for a moderate increase in the EU budget targeted to euro area wide unemployment and health insurance.

At the same, the banking union should proceed as planned, national reform efforts should be strengthened, especially in the periphery, and the stability and growth pact should be strictly enforced.



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# Transfer Union Arguments against a Euro Area Fiscal Reform

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All proposals for a rise in the EU budget go against the arguments of those opposing a transfer union, chiefly the countries that are net contributors to the EU budget, such as Germany, and a few of the smaller core economies.

I feel that these objections are misplaced. The EU and, in particular, the EA are already transfer unions, through the operation of the single market and the monetary union. They encourage significant economic transfers from weaker and less competitive sectors and economies in the periphery, to stronger and more competitive ones, as suggested by the macroeconomic performance of the core and the periphery following the creation of the Euro area.

A fiscal transfer union, which would partly correct the effects of such transfers through fiscal redistribution is a logical counterpart of the single market and the monetary union. The transfers I suggest are modest, but certainly higher than the current EU ceiling of 1% of GDP. They could be concentrated in key areas such as unemployment and health insurance and regional aid.

The objections of net contributors to a moderate increase in the EU budget could in principle be overcome by an appropriate rules based fiscal reform that would address moral hazard and other coordination problems.



# Real GDP per capita in the North and the South since the Creation of the Euro (1999=100)

