

Andrzej Sławiński

# Past, Present and Future of the Eurozone



# The main message of the presentation



- The European Union was an excellent step toward creating a United Europe
- The Eurozone was expected to crown the decades of integration efforts.
- Unfortunately its establishment turned out to be premature and generated unexpectedly large costs.

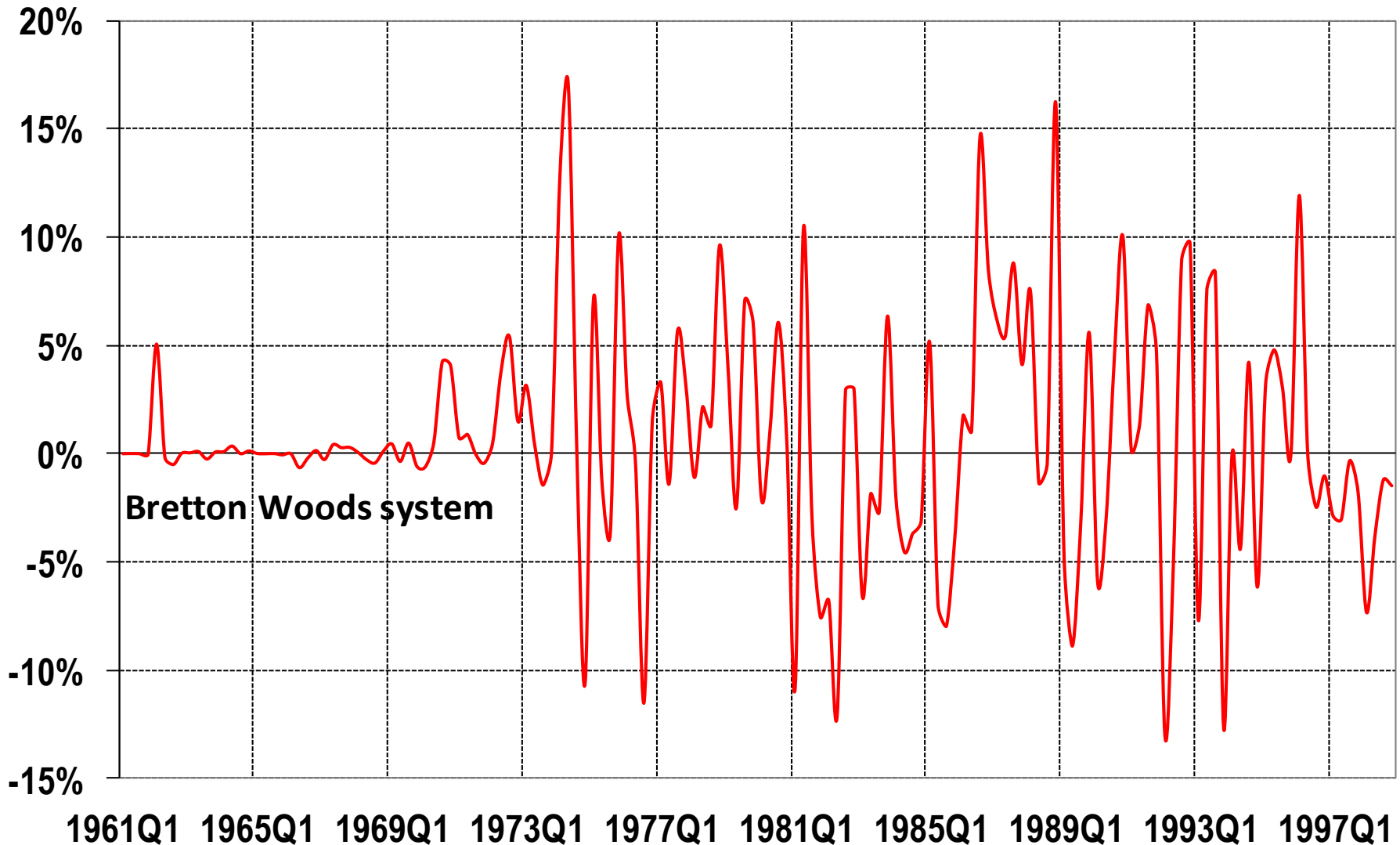
# 1

## The European Monetary System: The predecessor of the Eurozone

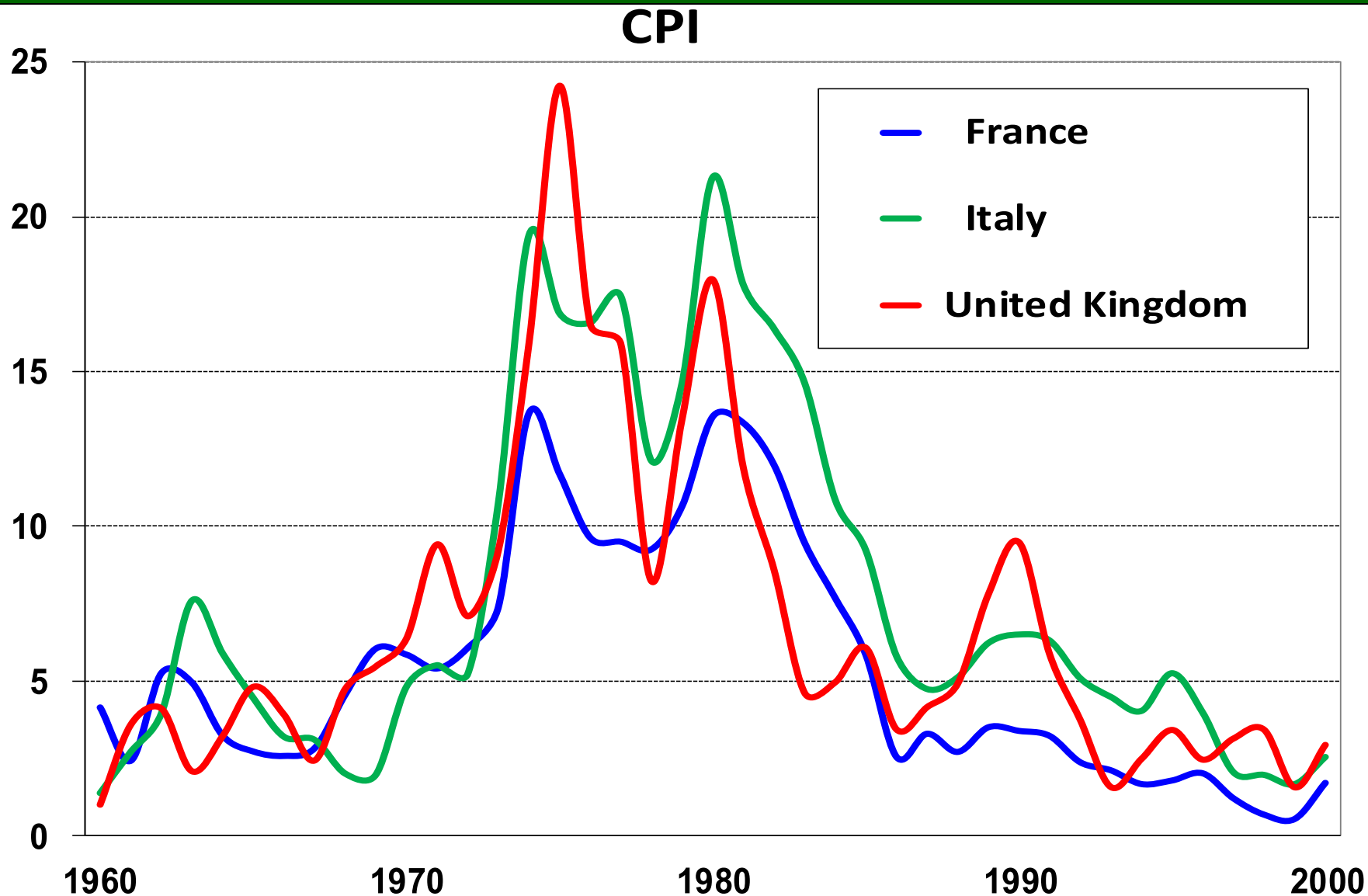


**The Downfall of the Bretton Woods system brought about unexpectedly high volatility of exchange rates**

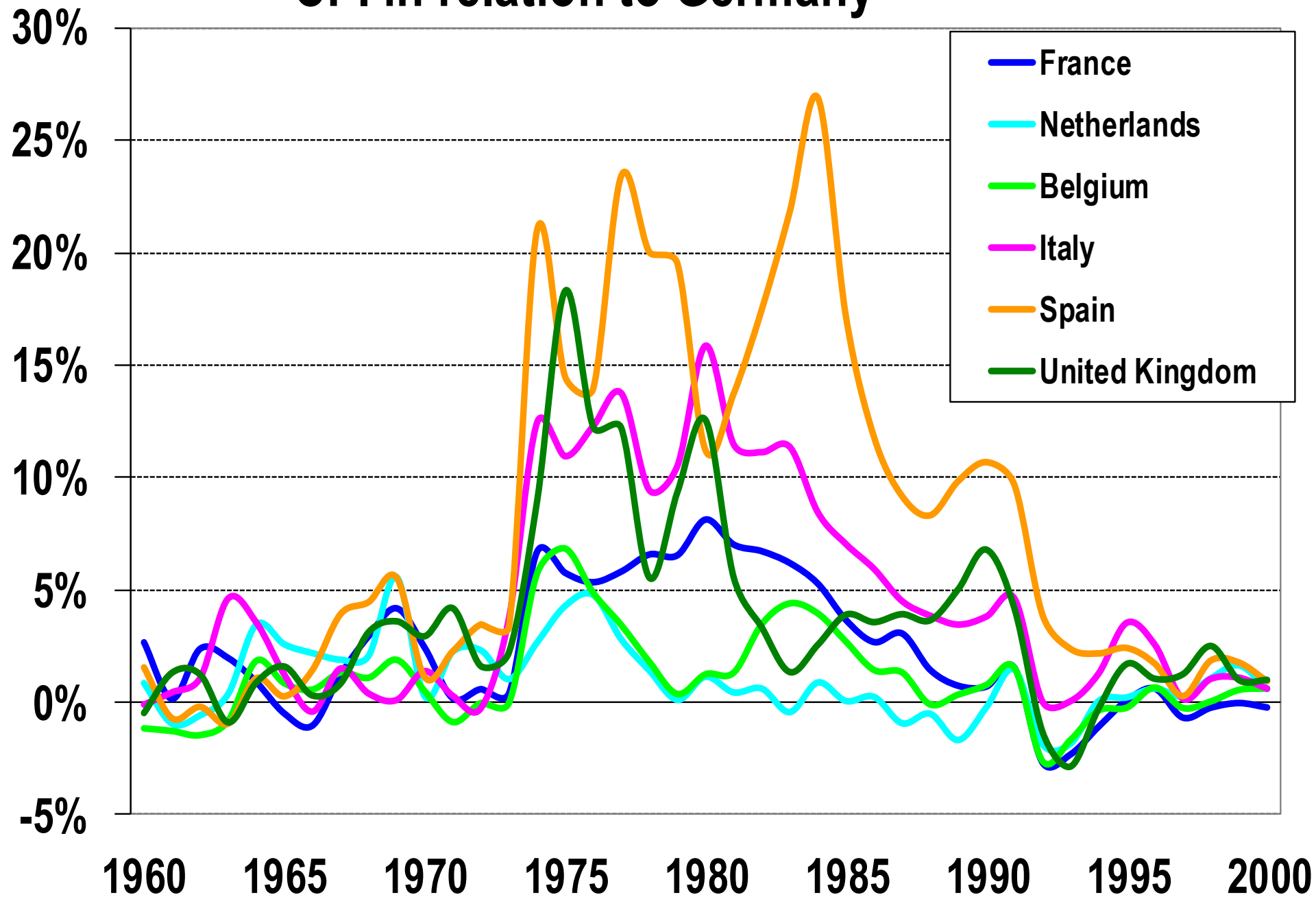
**DEM/USD**



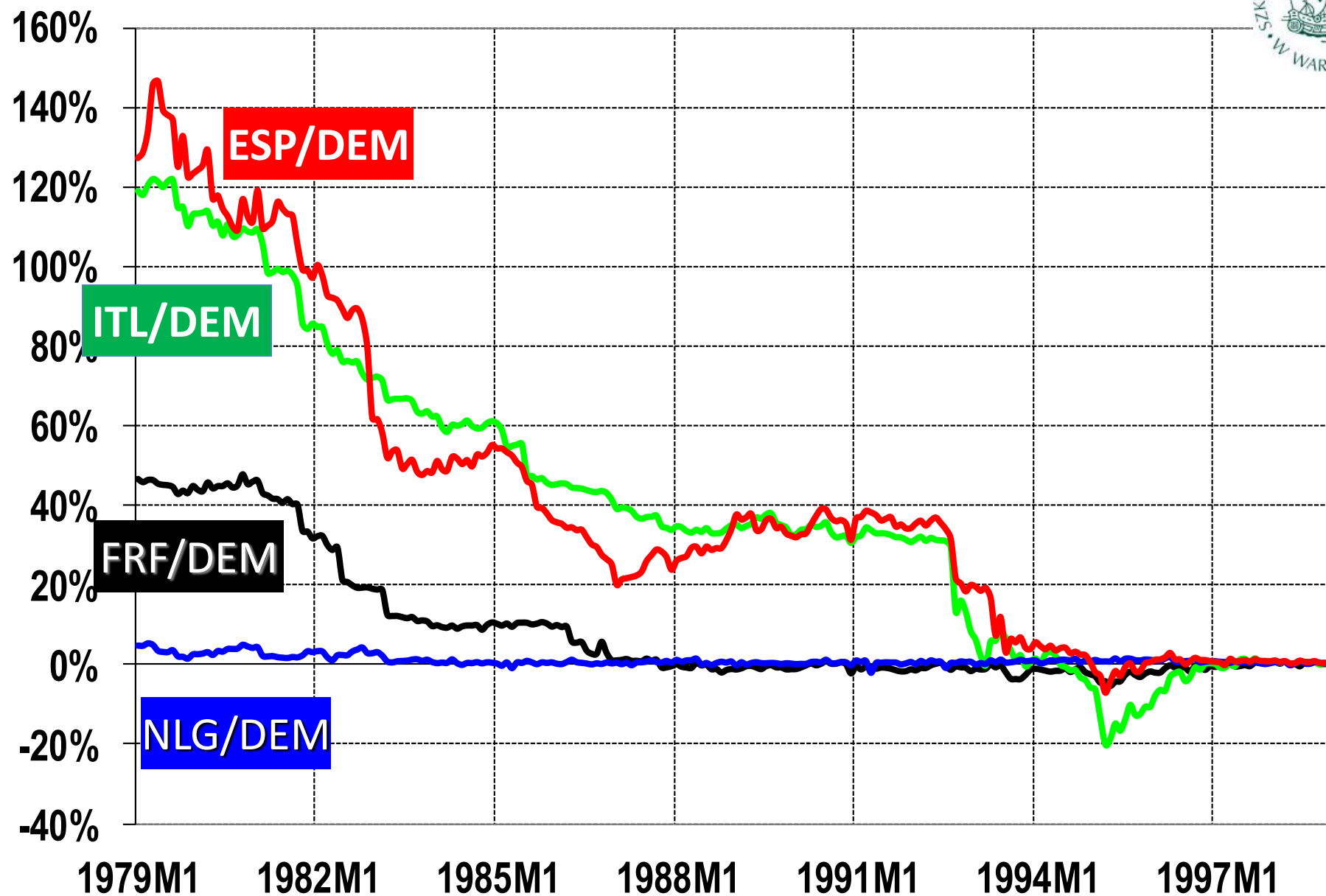
**In 1976 there was a real threat of  
a wage-inflation-and-currency-depreciation spiral in Europe**

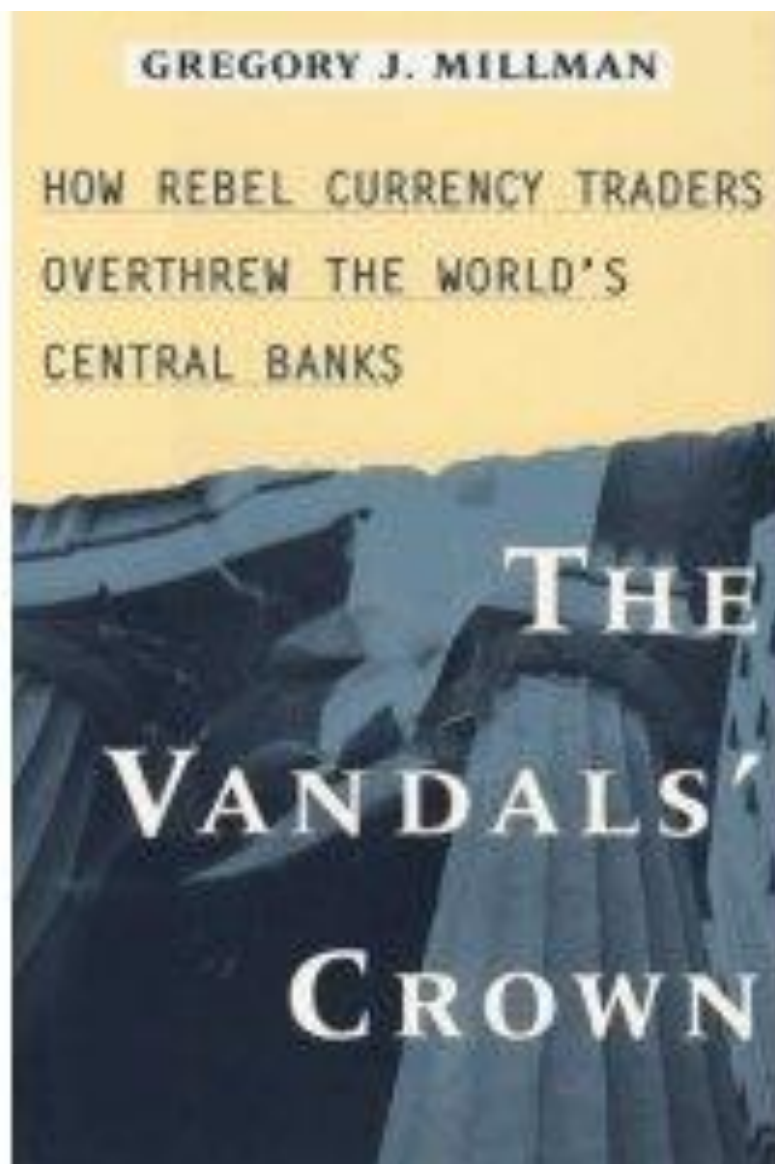


# CPI in relation to Germany



# Exchange rates against the DEM





# What enabled massive speculative attacks against the EMS currencies?



What was expected to shield the EMS  
against the destabilizing short-capital flows?



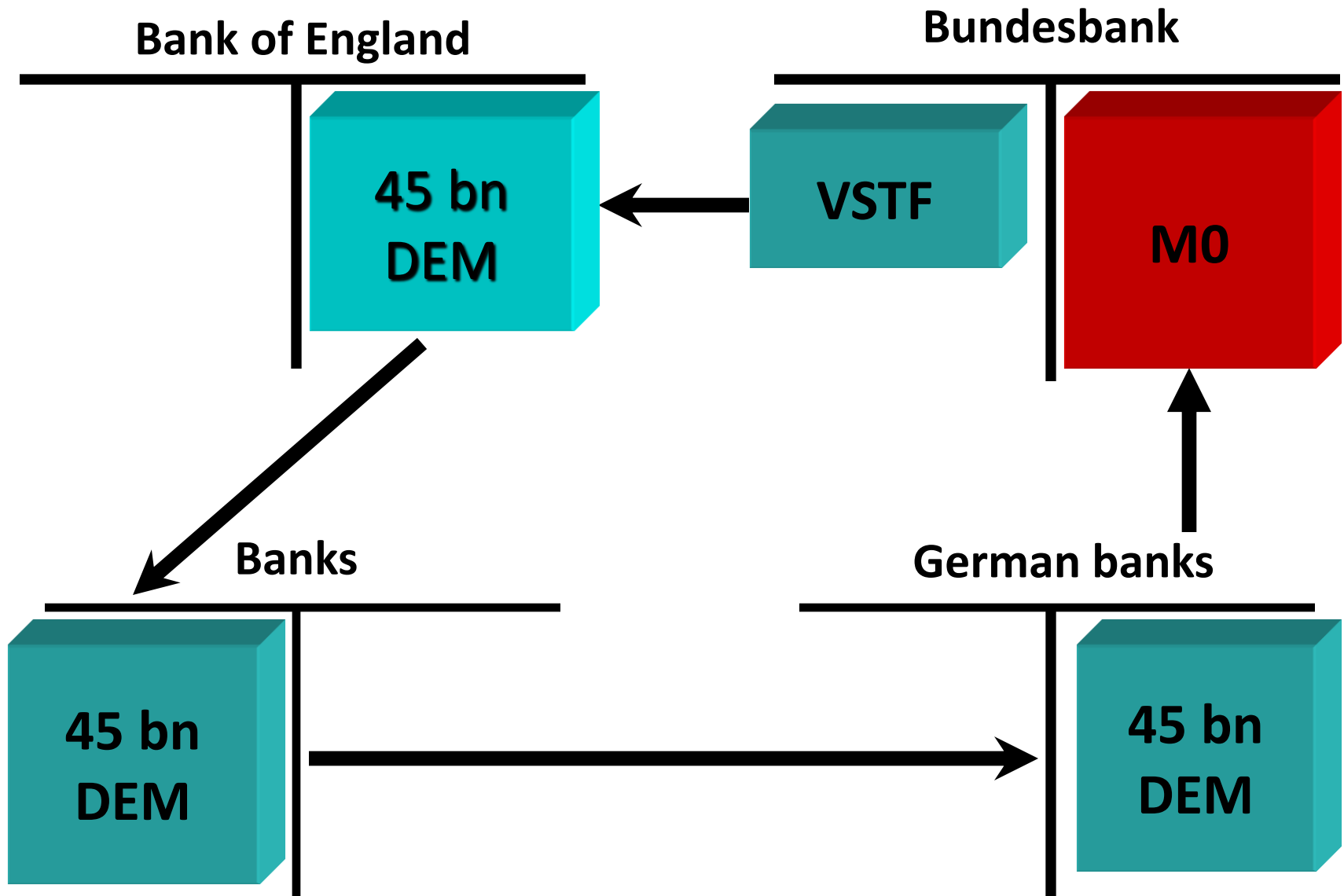
**Very  
Short-Term  
Financing Facility**



**VSTFF**

**Why didn't the VSTFF Wall shield the pound?**

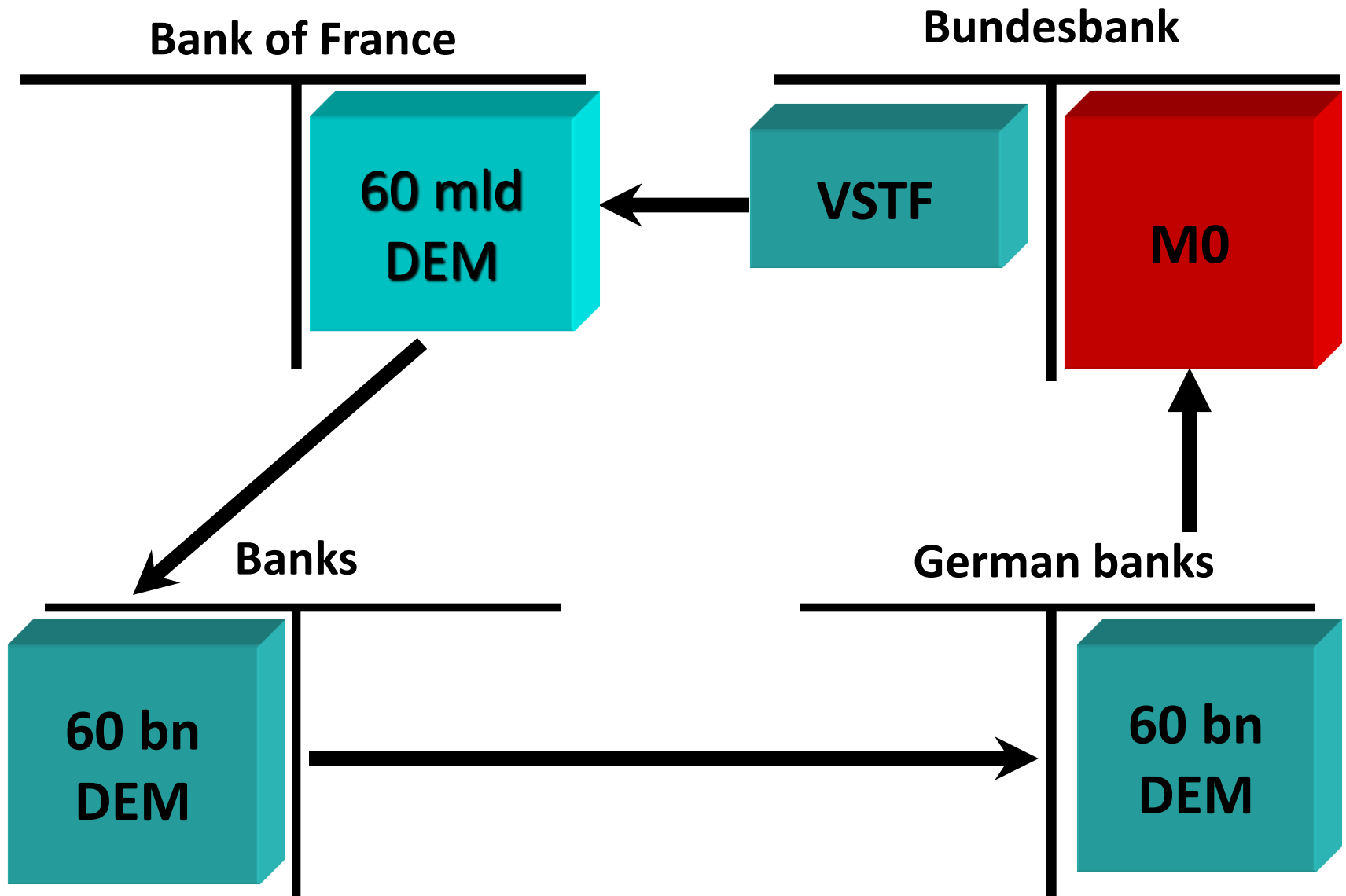
# September 1992



**VSTFF**

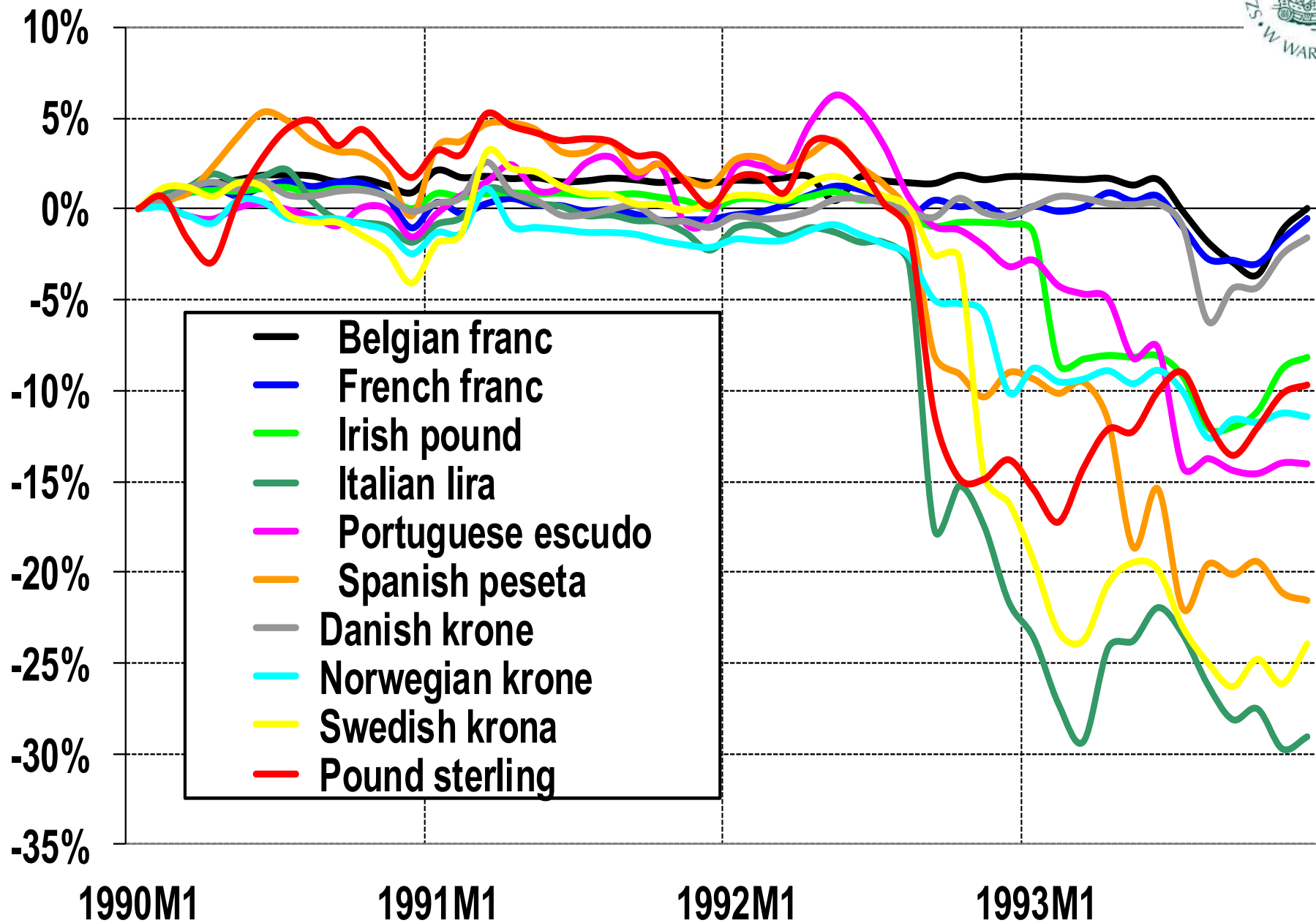
Why didn't the VSTFF Wall shield the franc?

July 1993



- In 1992-93, *all* EMS currencies were attacked (with the exception of Austrian Shilling and Dutch Guilder)

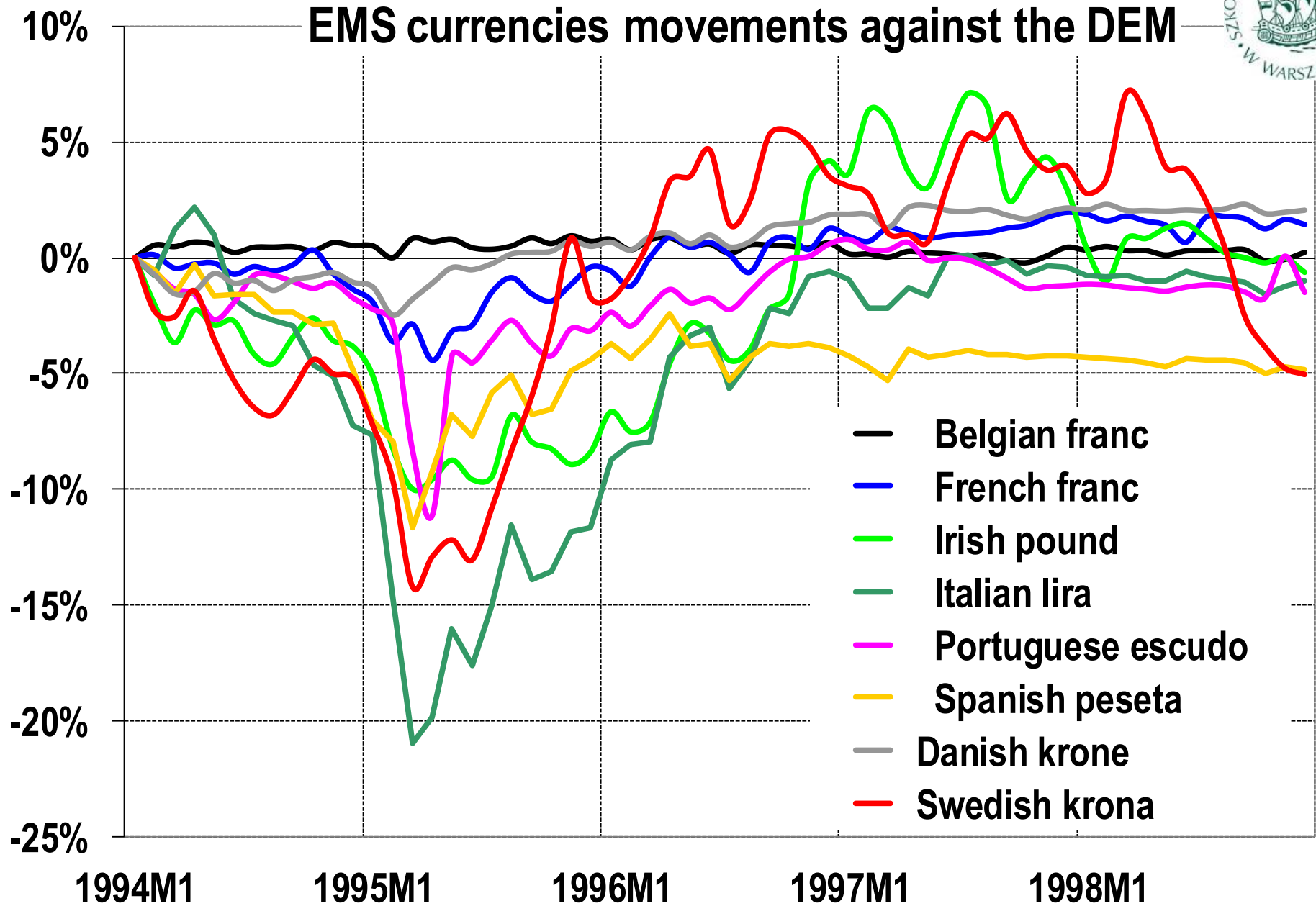
# The EMS currencies against the DEM



- In July 1993, the ERM bands were widened from 2.25% to **15%** to increase the risk of taking part in a speculative attack.

# The aftershocks:

## EMS currencies movements against the DEM



- Speculative attacks against the EMS currencies were spectacular, but they were only speculative attacks. They did not trigger banking crises or recessions.
- *Ex post* we know that by introducing the euro too early **Europeans swapped the risk of being exposed to speculative attacks into the risk of being hit by harmful fiscal crises.**

# 3

## Introducing of the euro: A bridge too far





- The Euro has been the outcome of Europe's 19th and 20th century history rather than 'optimal currency areas' logic.
- An upbeat optimism may help overcome opposition.

# The assumptions that shaped institutional structure of the euro zone



Costs of resigning from monetary policy are negligible

Only public sector deficits are destabilizing

Current account deficits result exclusively from the real convergence

# THE FIRE CODE

OFFICE OF THE FIRE MARSHAL

MINISTRY OF THE SOLICITOR GENERAL AND CORRECTIONAL SERVICES



# The Stability and Growth Pact

The architecture of  
fiscal policy in EMU

edited by Anne Brummé, Marco Buti  
and Daniele Franco



- The lack of a fire brigade from the very beginning.





- Union could only work if there was an explicit insurance mechanism.
- In fact, economic analysis **prior to the start of the eurozone stressed** that a monetary union should be coupled with a **budgetary union**.
- This was put already in the **MacDoughall report** in the 1970s (EU Commission: Report of the Study Group on the Role of Public Finance in European Integration, Brussels **1977**)

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT  
OF THE STUDY GROUP ON  
THE ROLE OF PUBLIC FINANCE  
IN EUROPEAN INTEGRATION

Volume I : General Report

Brussels

April 1977



# EUROPEAN ECONOMY

COMMISSION OF THE EUROPEAN COMMUNITIES  
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS



**STABLE MONEY — SOUND FINANCES**

Community public finance in the  
perspective of EMU

No 53

1993

**How would Mazury lake district ended up, had it not received transfers from the central budget in Warsaw?**



[http://www.singielwpodrozy.pl/urok/lubelskie/uroki-polski-wschodniej/attachment/warmia-i-mazury-lidzbark-warminski-swietalipka-gierloz-gizycko-ruciane-mikolajki\\_1](http://www.singielwpodrozy.pl/urok/lubelskie/uroki-polski-wschodniej/attachment/warmia-i-mazury-lidzbark-warminski-swietalipka-gierloz-gizycko-ruciane-mikolajki_1)

- Dolny Śląsk



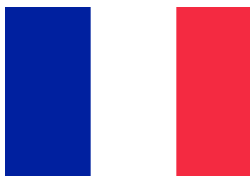
- Warmia i Mazury

- Northrhein-Westfalen



- Mecklenburg-Vorpommern

- Alsace



- Languedoc-Rosussillon

- Lombardia



- Sicilia

- Aragón



- Andalucía

- Cheshire



- Cornwall & Isles of Scilly

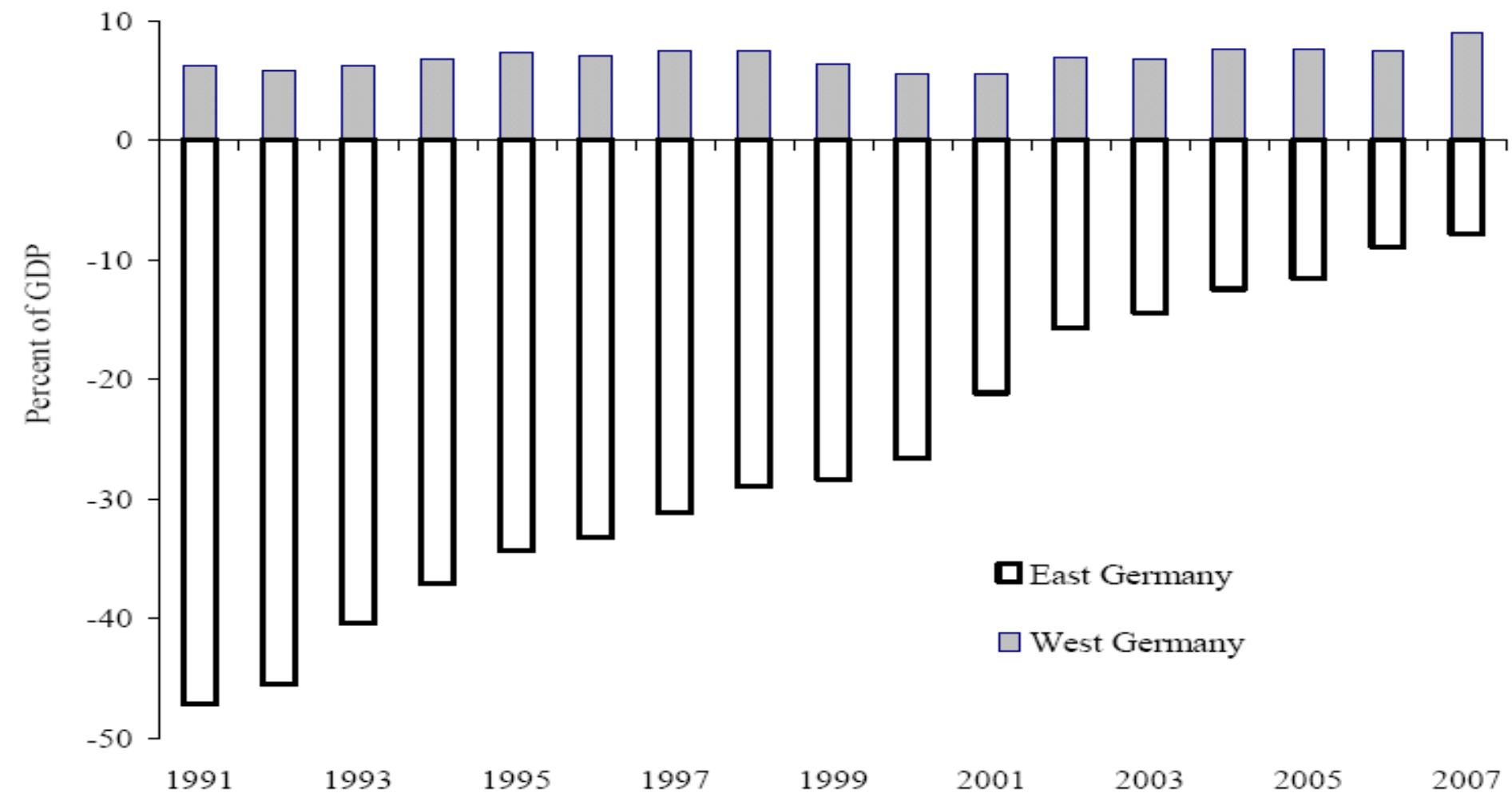
- “...under the rules of the game in monetary union, there are **no...economic policy alternatives to the path embarked upon here in Germany**”
- „...**Germany’s experience** is suited to serve as **a model for other euro-area countries** confronted by problem of diminishing price competitiveness”

# **TRANSFER UNION**

- „East Germany has made tremendous progress in balancing its current account.
- Due to the **recovery of its manufacturing industry** East Germany's economy has managed to **overcome the total dependency on transfer payments**”.

Karl-Heinz Paque, *The Transformation Policy in East Germany – A Partial Success Story*, 20 Years after the Berlin Wall, Konrad Adenauer Stiftung, 2009

Figure 7 – Current Account Balance of West and East Germany as Percent of GDP



Source: Destatis, own calculations based on regional national account figures.

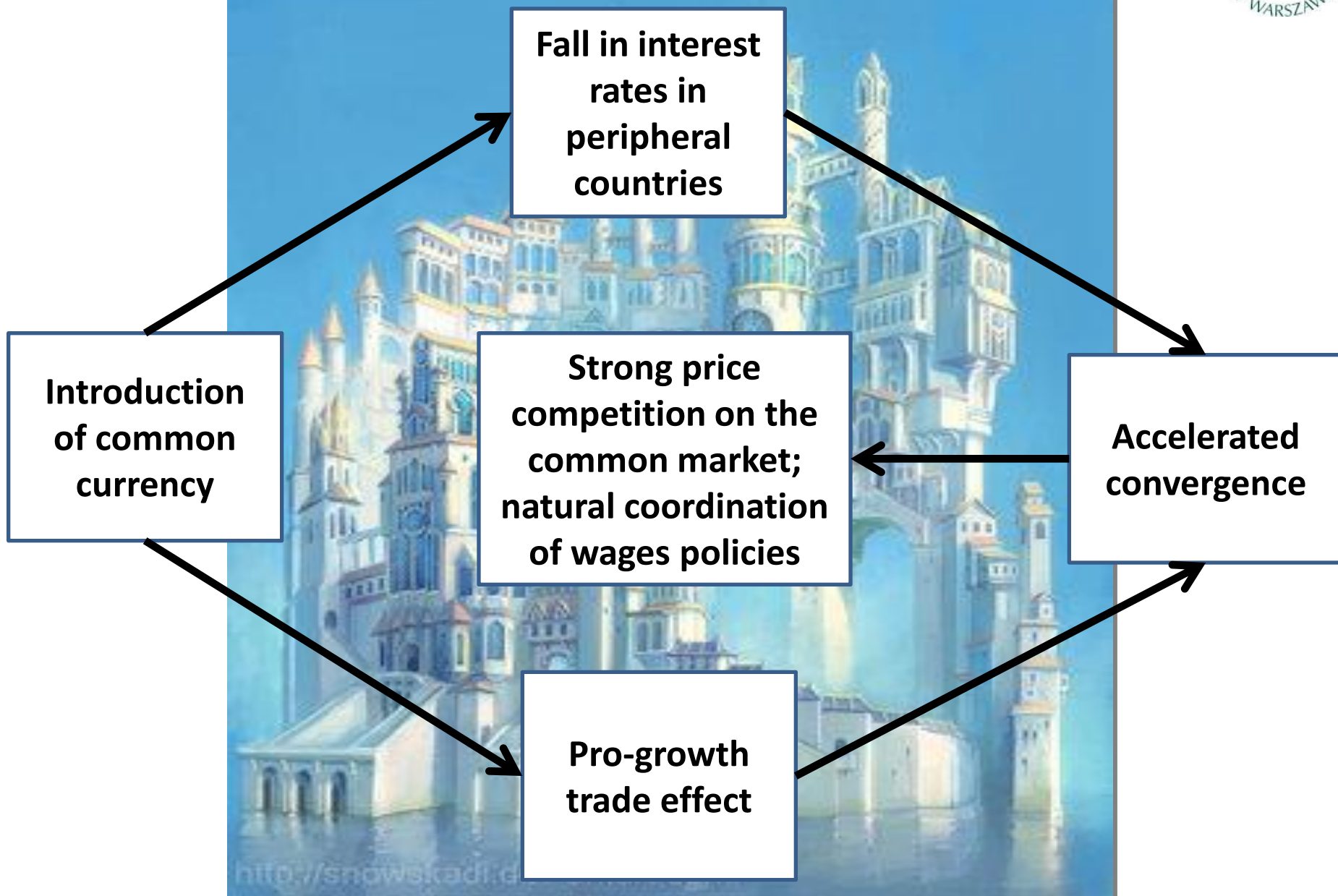
**Gunther Schnabl, Holger Zemanek (2010). Inter-temporal Savings, Current Account Dynamics And Asymmetric Shocks in a Heterogeneous European Monetary Union, CESifo Working Paper, No. 2010, December**

# 4

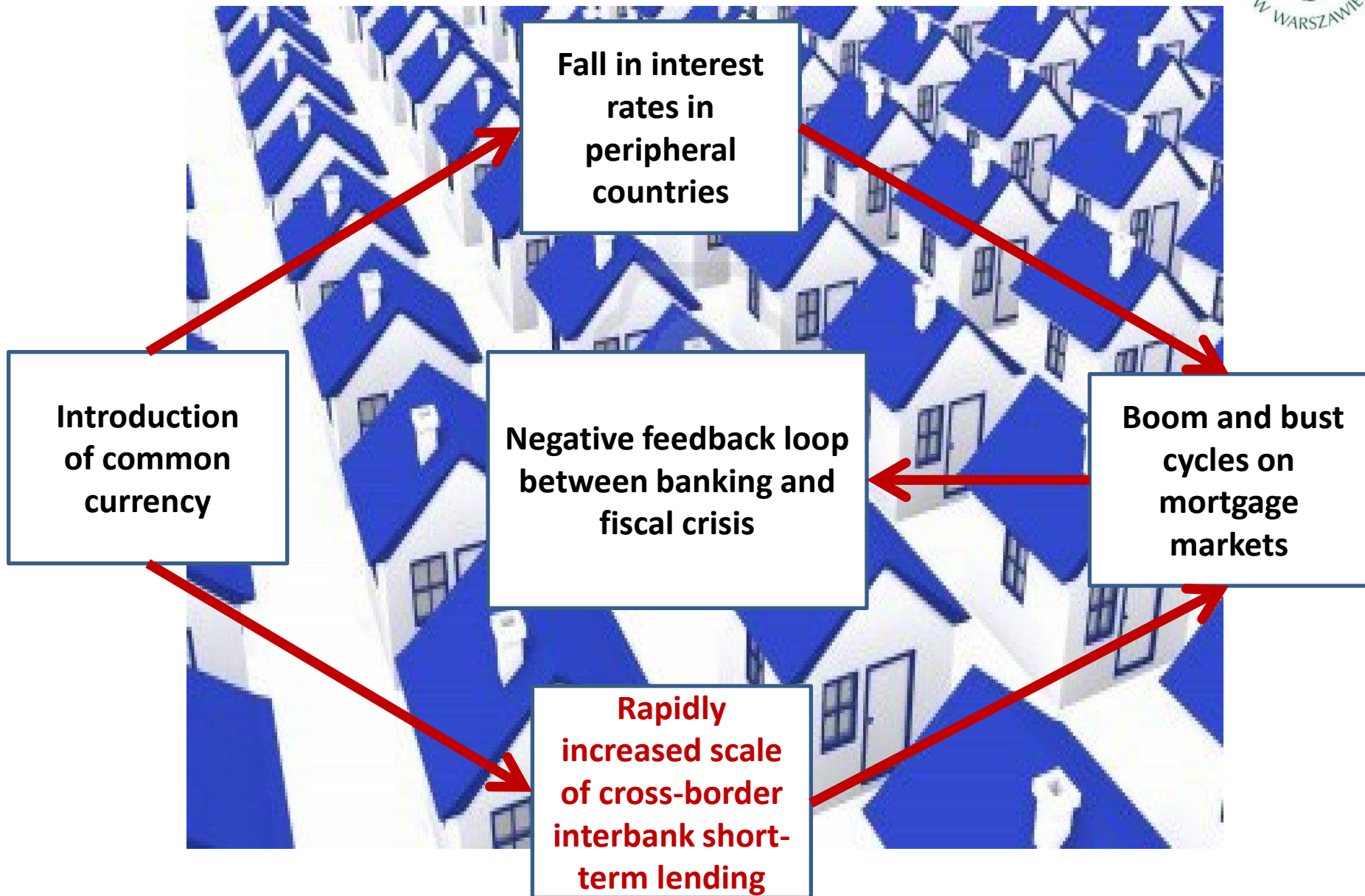
## The causes and consequences of the boom and bust cycle



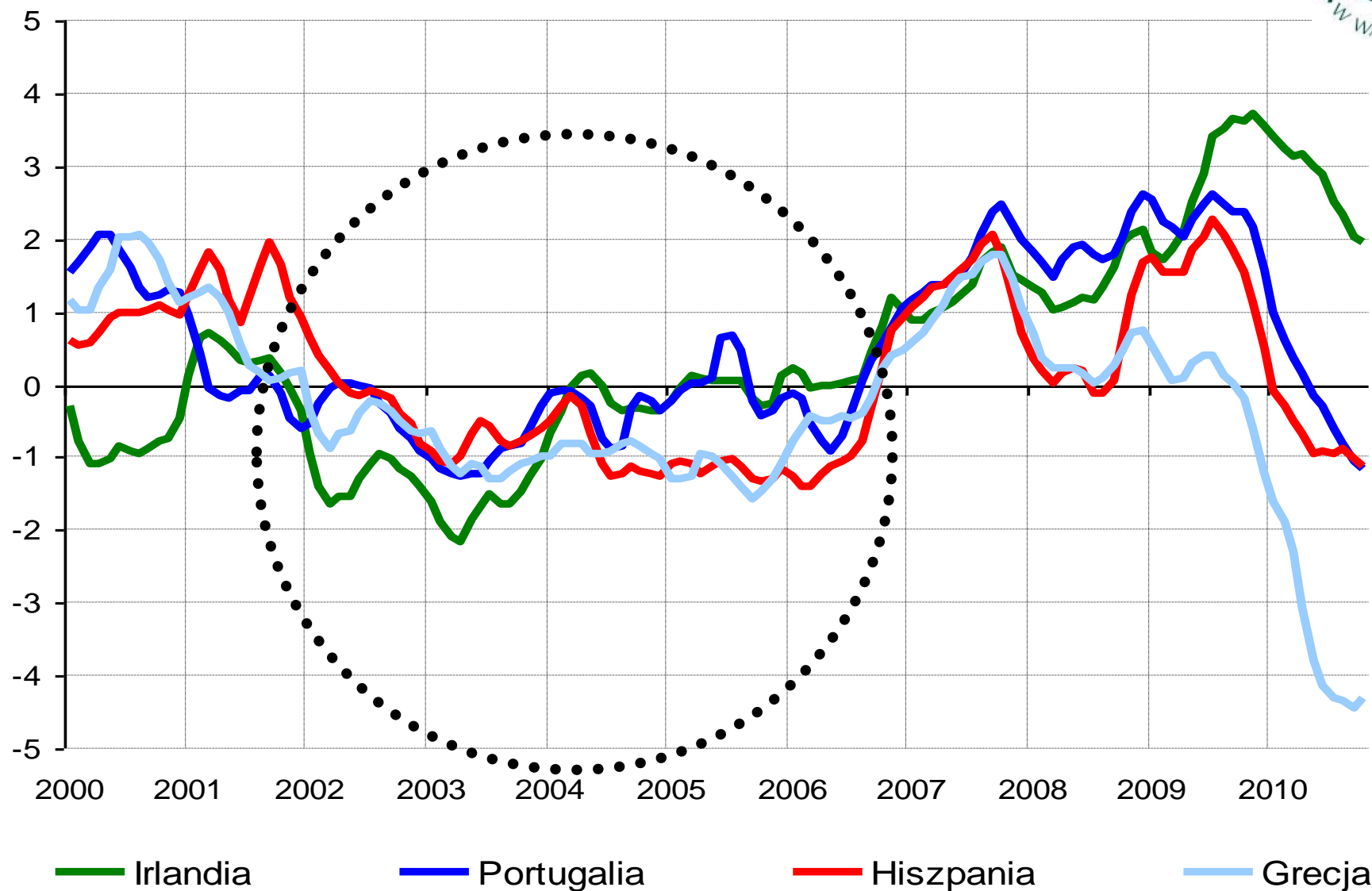
# The expectations...



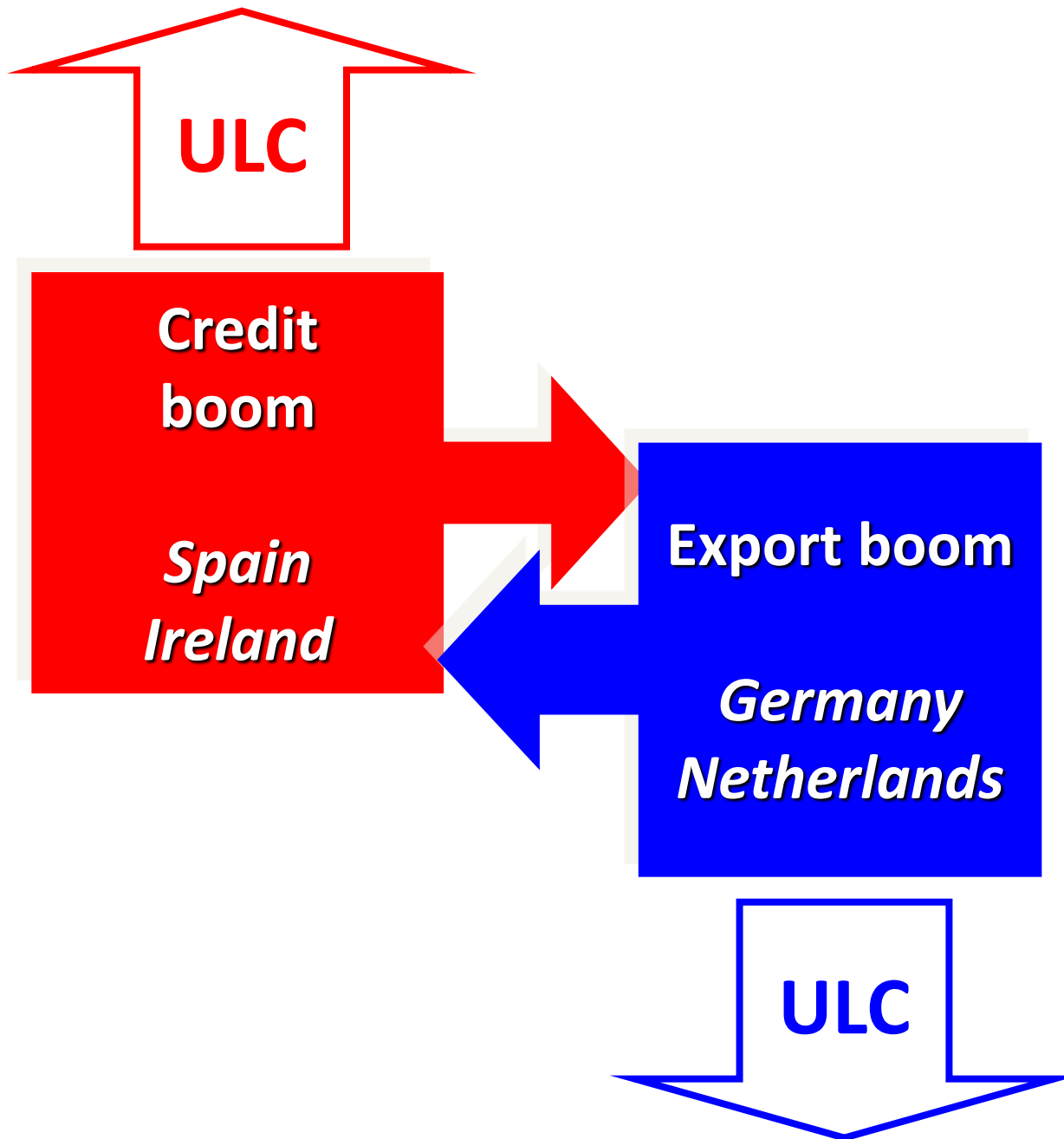
# ...and the real outcome



# Negative real interest rates

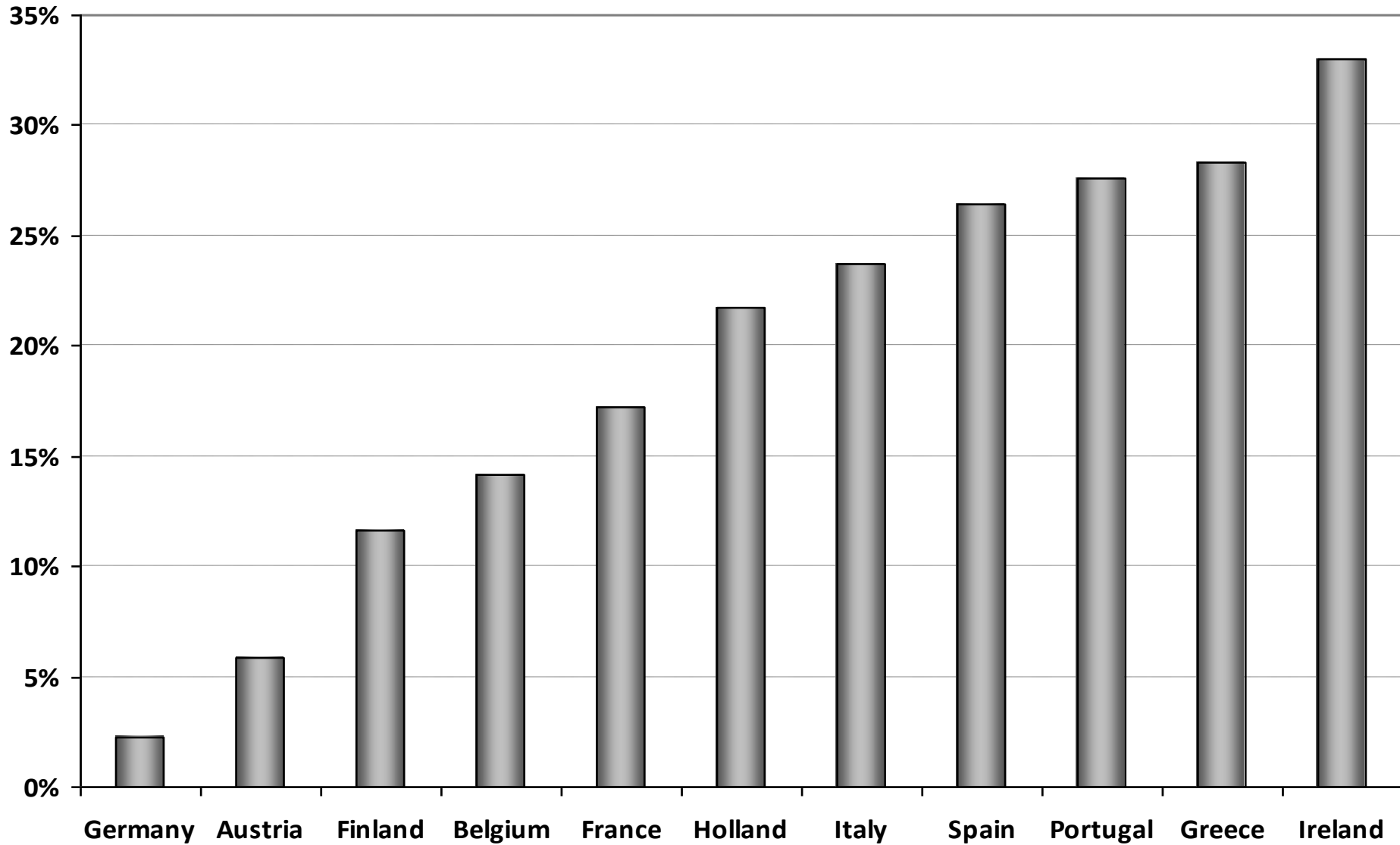


- The real estate bubble has overshadowed the lack of competitiveness of the Spanish economy.
- While the construction sector is booming (over 700,000 houses were built **in Spain** in 2004, **more than the total in France, Germany, Belgium, Holland and Luxembourg combined**),
- manufacturing production regressed 0,4 percent in 2005 (the automotive sector declined almost 9 percent in 2005) and
- exports was not experiencing almost any growth.



- **One of the surprises** of the functioning of the Eurozone has been the extent to which the **competitive positions** of the Eurozone countries have **diverged**.
- Germany which by applying tough wage moderation since 1999, dramatically improved its competitive position within the Eurozone at the expense of other countries.

## Cumulated ULC growth: 1999-2007



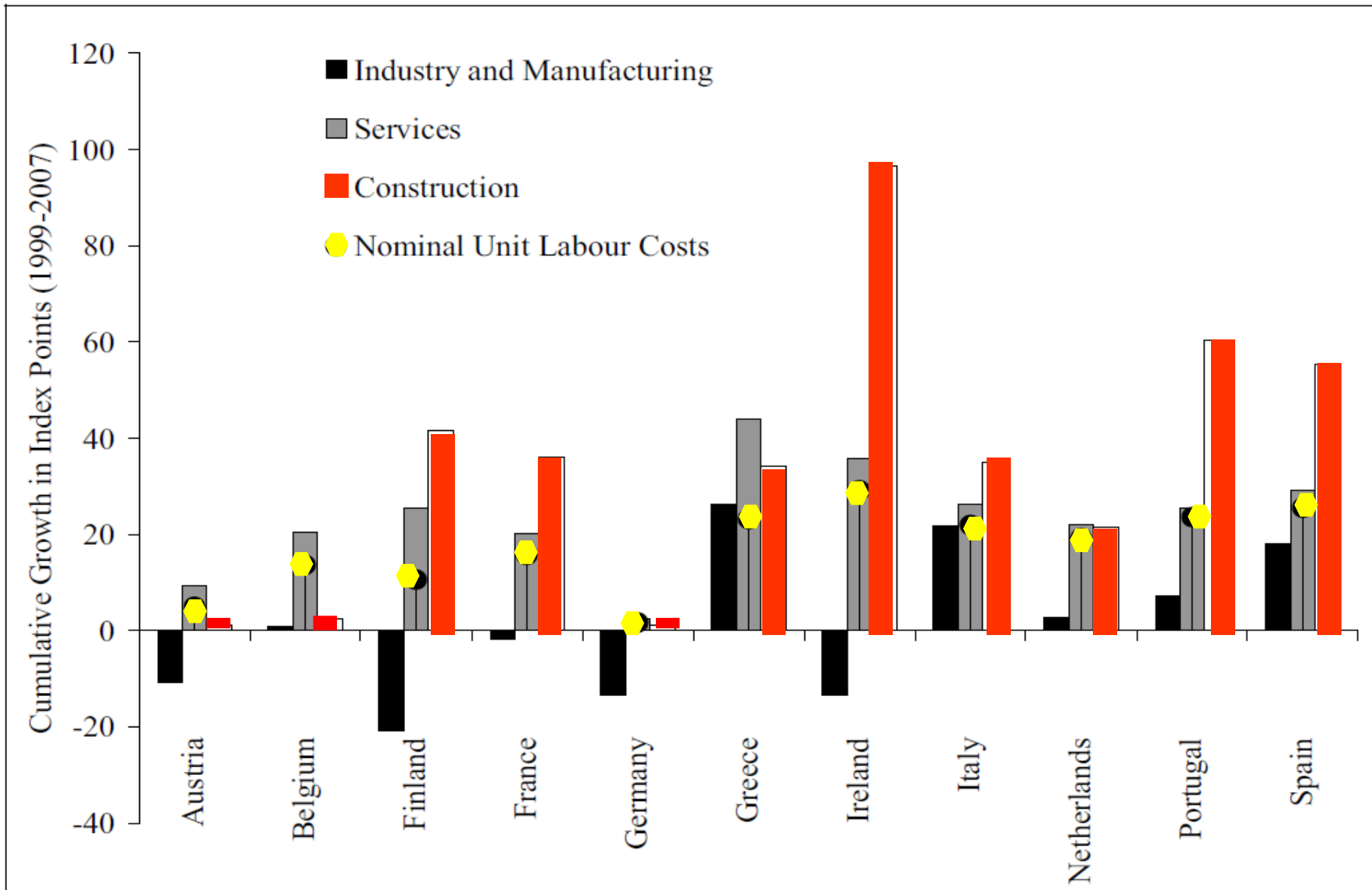


“We cannot afford to invest any more money in **cement** for the next 10 years. We have to spend all our available funds on improving the competitiveness of the export sector.”

Fernando Ulrich,  
chief executive of Banco BPI

„Portugal: Peripheral nerves”, *Financial Times*, 7 November 2010

*Nominal unit wage costs by major sectors and overall unit labour costs, cumulative changes in index points 1999-2007*



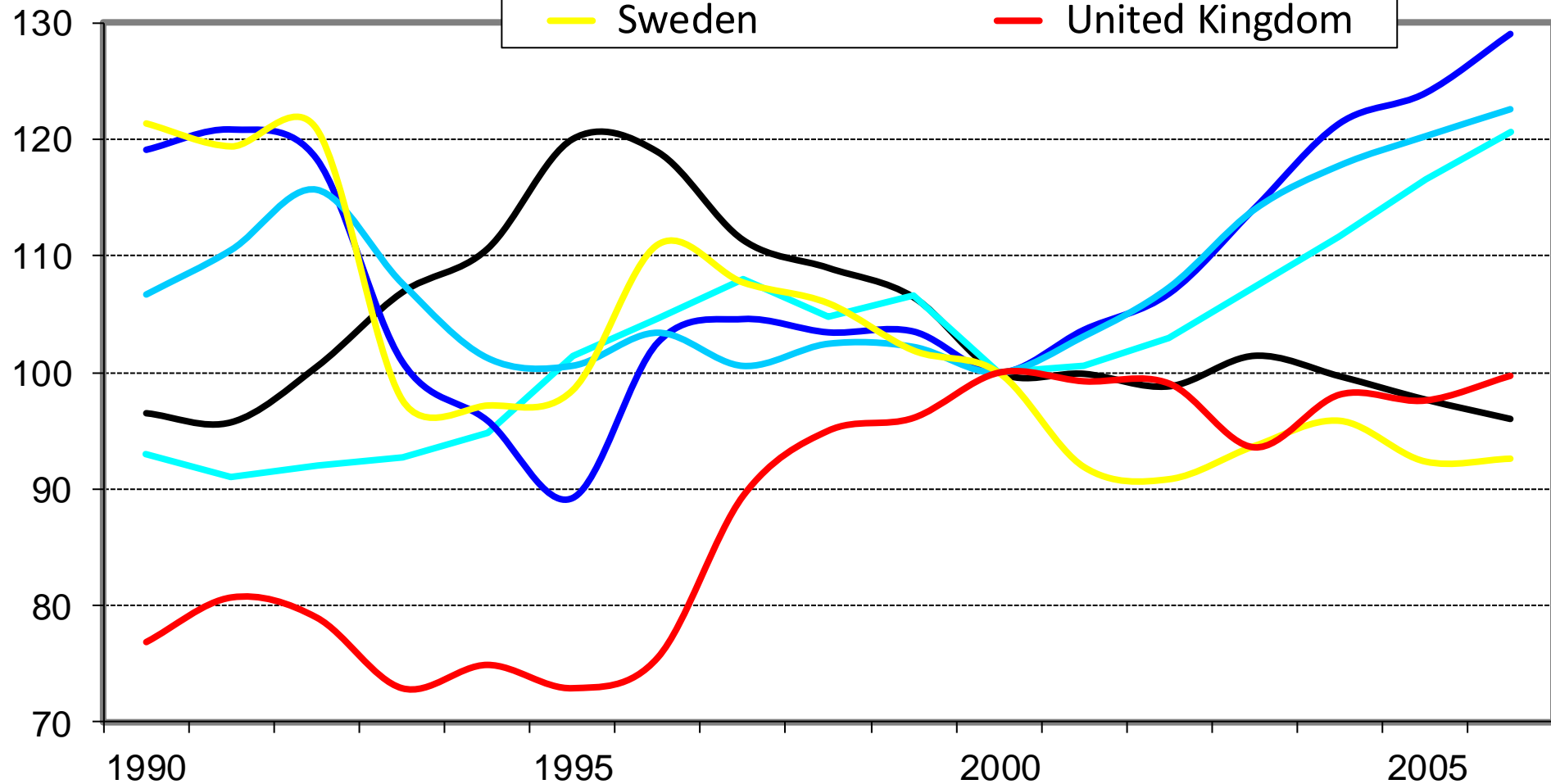
# Sharp appreciation of REERs in Eurozone Southern countries



**ULC deflated REER**

— Germany  
— Italy  
— Sweden

— Greece  
— Spain  
— United Kingdom



# 5

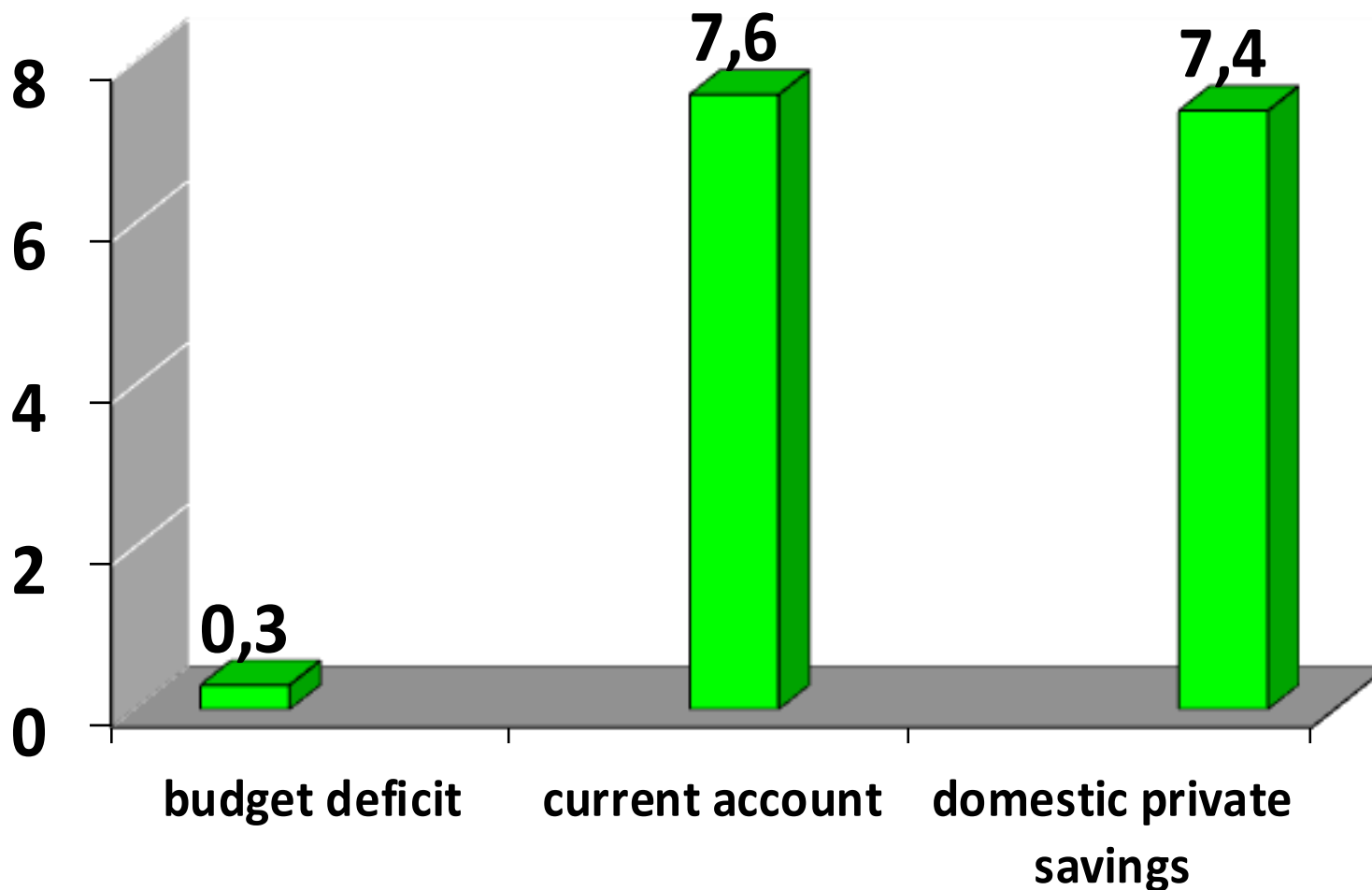
## The asymmetry of adjustment



**Could Germany and the Netherlands afford to postpone balancing their budgets?**

% of GDP

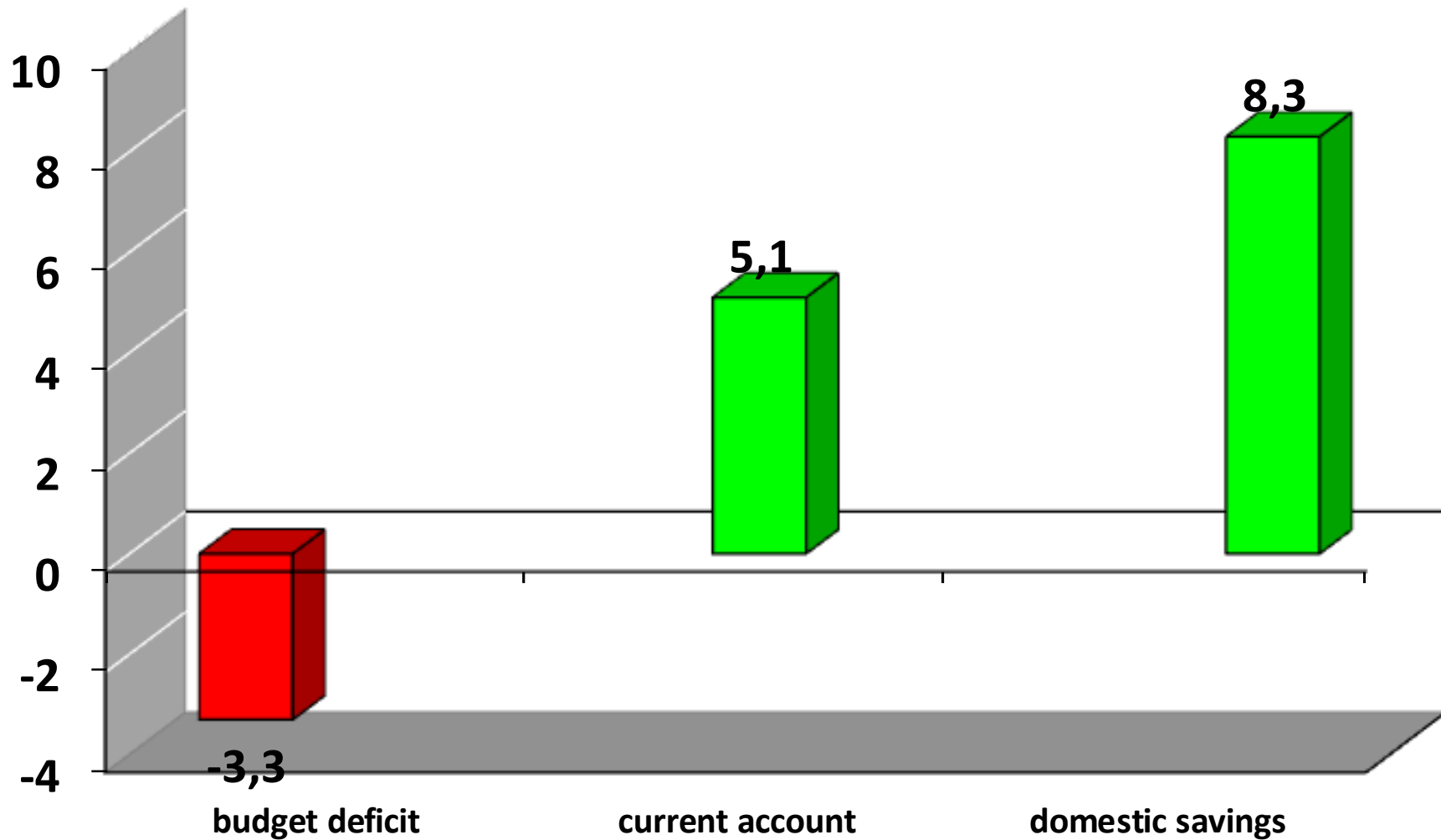
## Germany 2007



Gregor Siemieniuk, Till van Treeck, Achim Truger (2011), Reducing Economic Imbalances In the Euro Area: Some Remarks on the Current Stability Programs: 2011-2012. Working Paper no. 694, Levy Institute, October

% of GDP

# Germany 2010

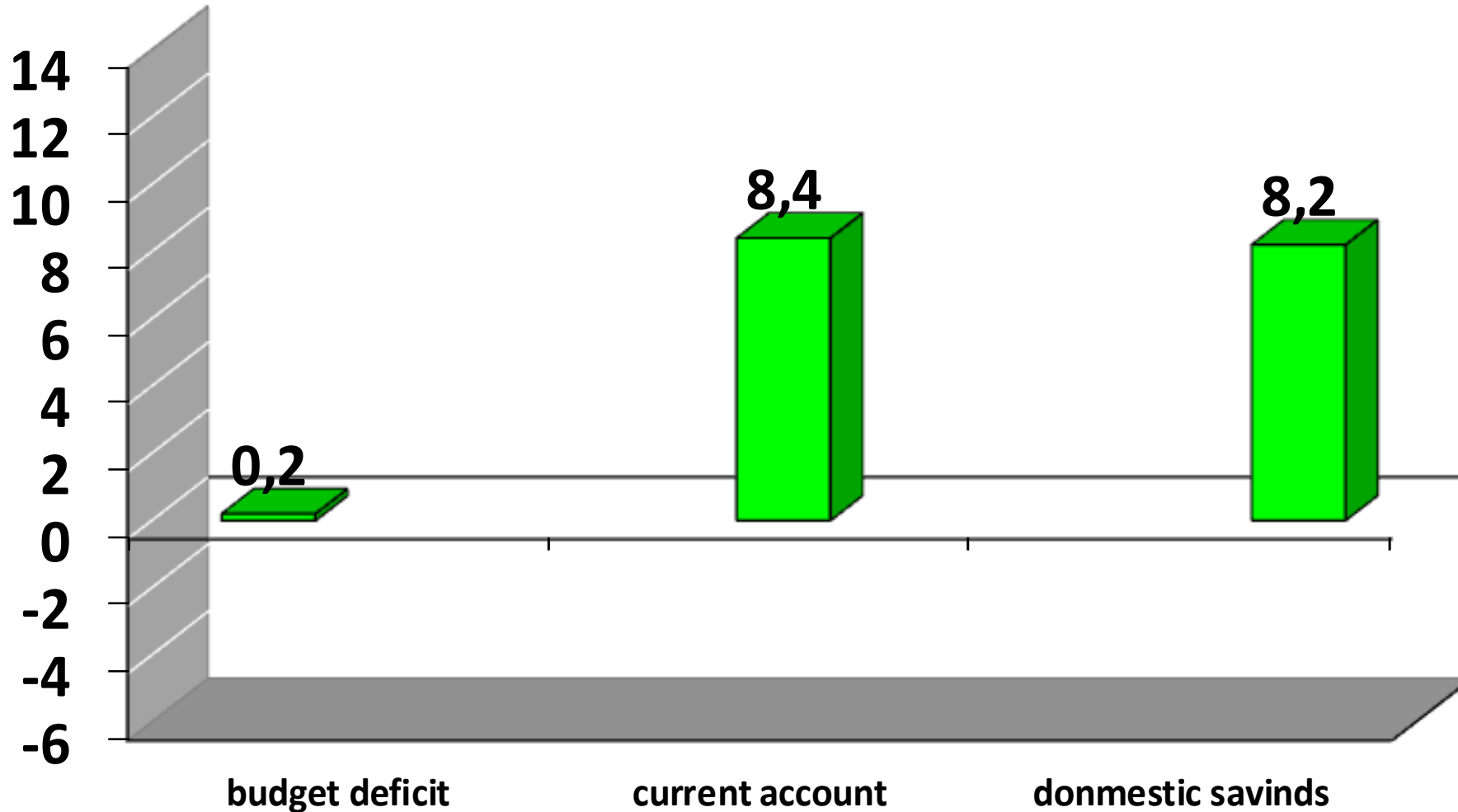


Gregor Siemieniuk, Till van Treeck, Achim Truger (2011), Reducing Economic Imbalances In the Euro Area: Some Remarks on the Current Stability Programs: 2011-2012. Working Paper no. 694, Levy Institute, October

# Netherlands 2007



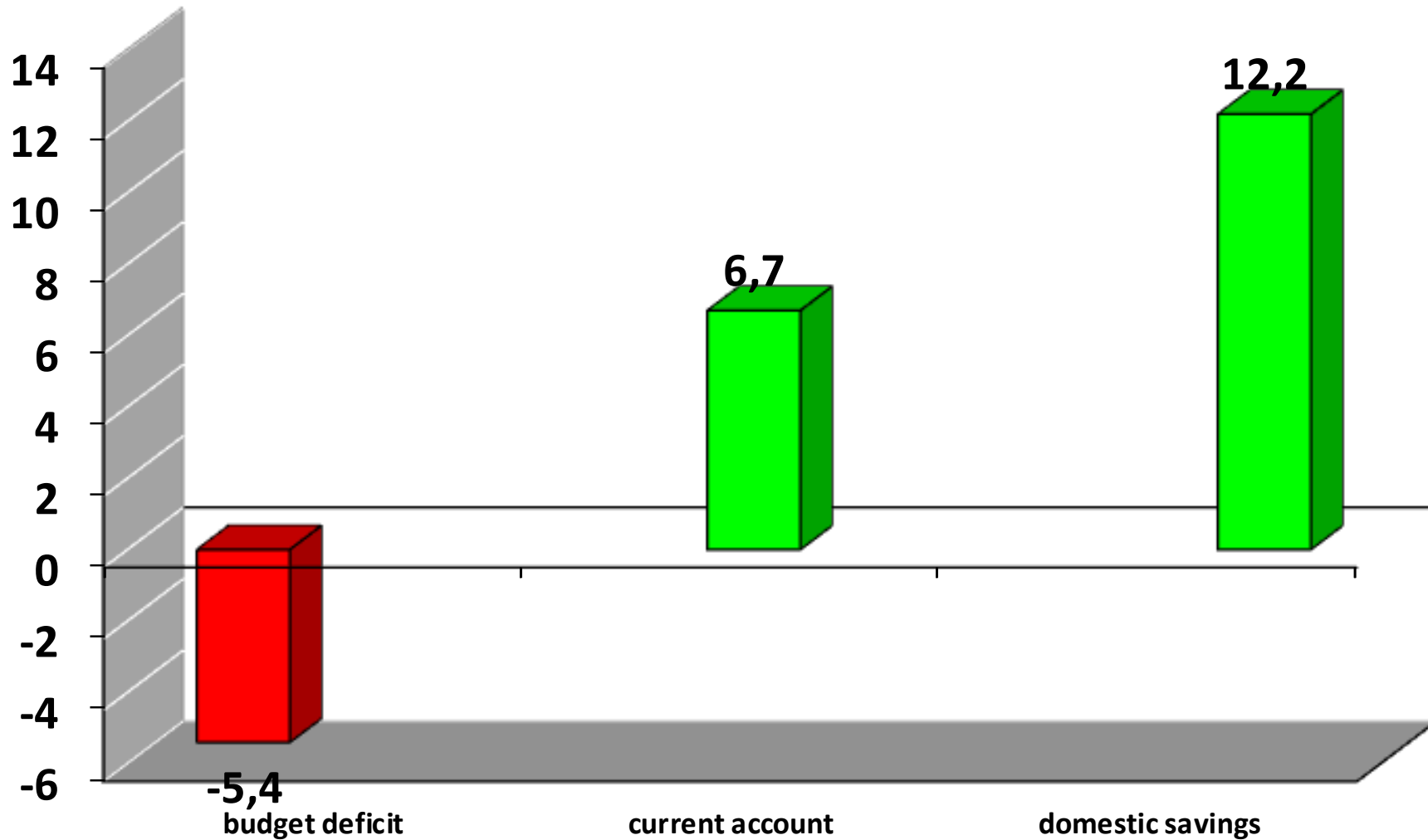
% of GDP



Gregor Siemieniuk, Till van Treeck, Achim Truger (2011), Reducing Economic Imbalances In the Euro Area: Some Remarks on the Current Stability Programs: 2011-2012. Working Paper no. 694, Levy Institute, October

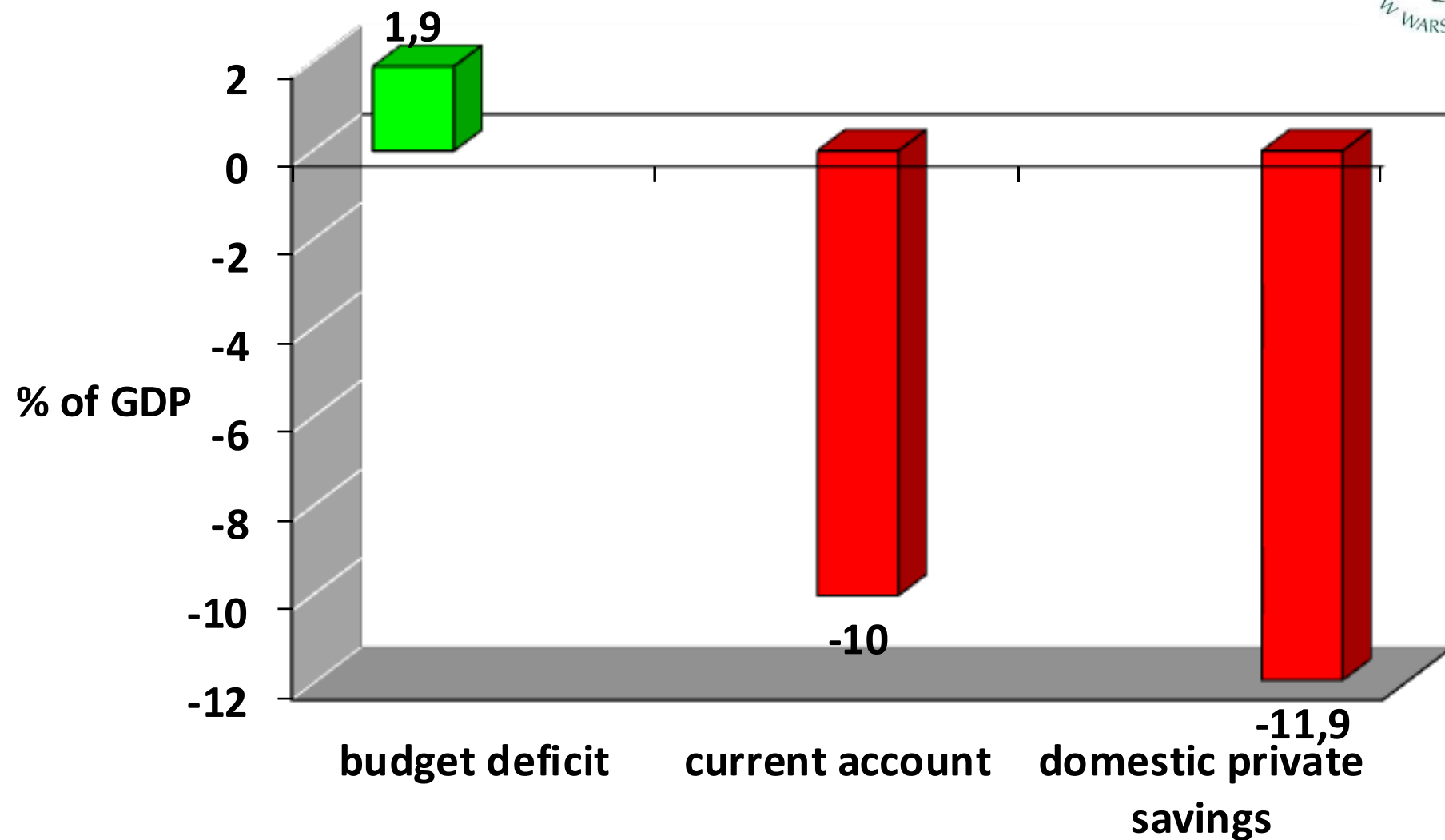
% of GDP

# Netherlands 2010



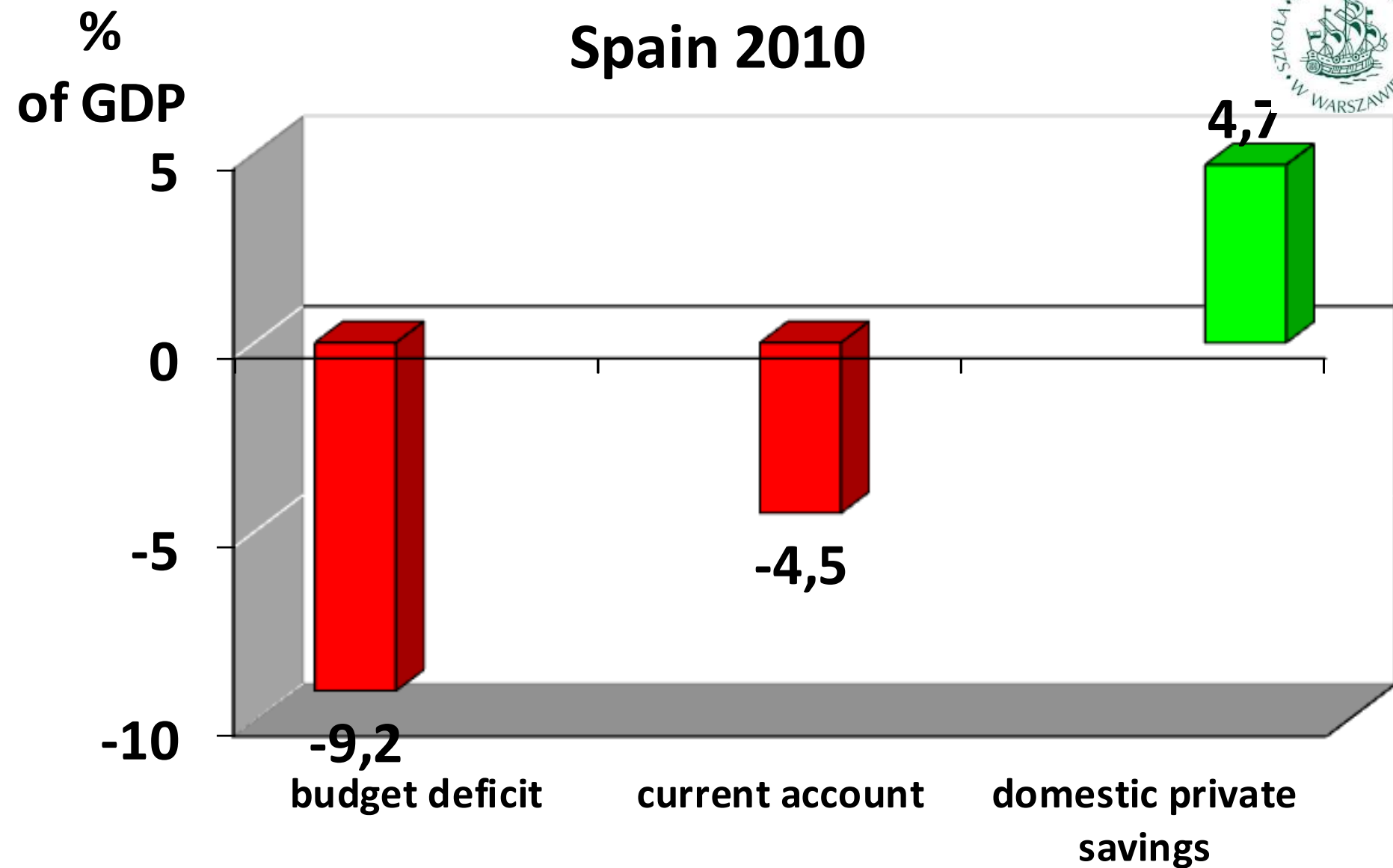
Gregor Siemieniuk, Till van Treeck, Achim Truger (2011), Reducing Economic Imbalances In the Euro Area: Some Remarks on the Current Stability Programs: 2011-2012. Working Paper no. 694, Levy Institute, October

# Spain 2007



Gregor Siemieniuk, Till van Treeck, Achim Truger (2011), Reducing Economic Imbalances In the Euro Area: Some Remarks on the Current Stability Programs: 2011-2012. Working Paper no. 694, Levy Institute, October

## Spain 2010



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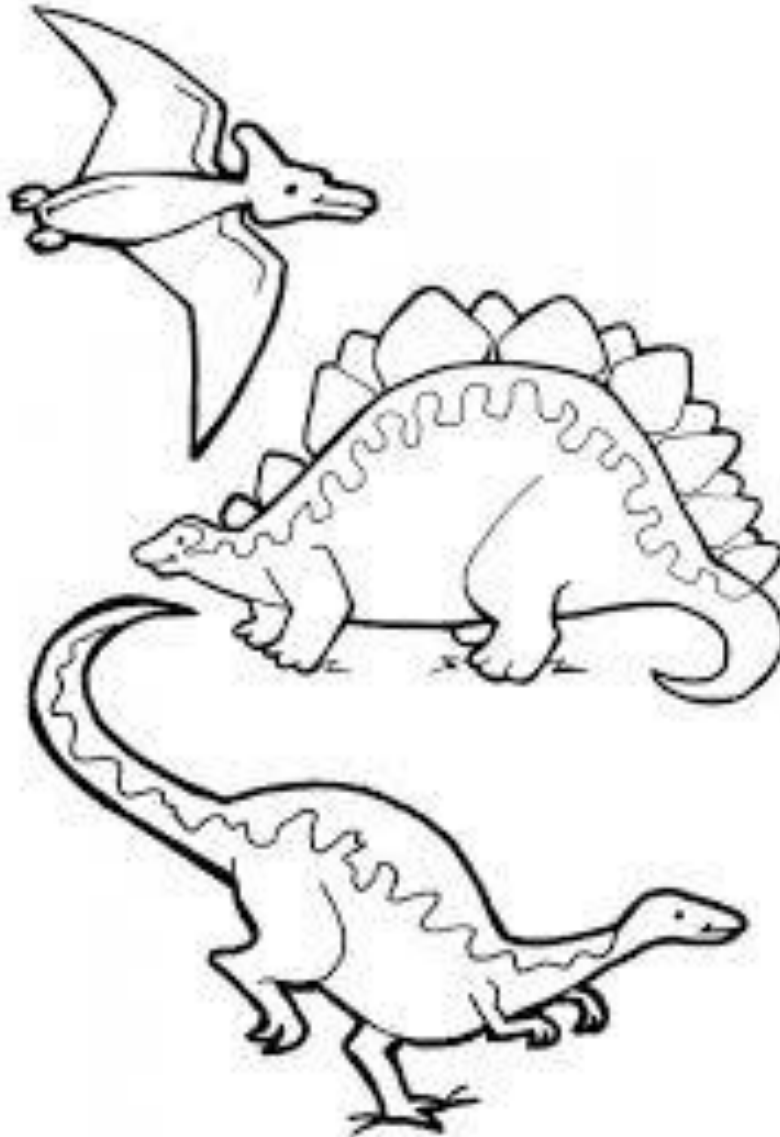
**Why did the ECB have to announce the OMT ?**



- Governments of the Southern Eurozone countries did not realize that borrowing in the common currency was like borrowing in a foreign currency as their central banks could not intervene on Treasury bond markets.
- Before the ECB announced the OMT Italy and Spain could not defend themselves against speculation on their Treasury bond markets.

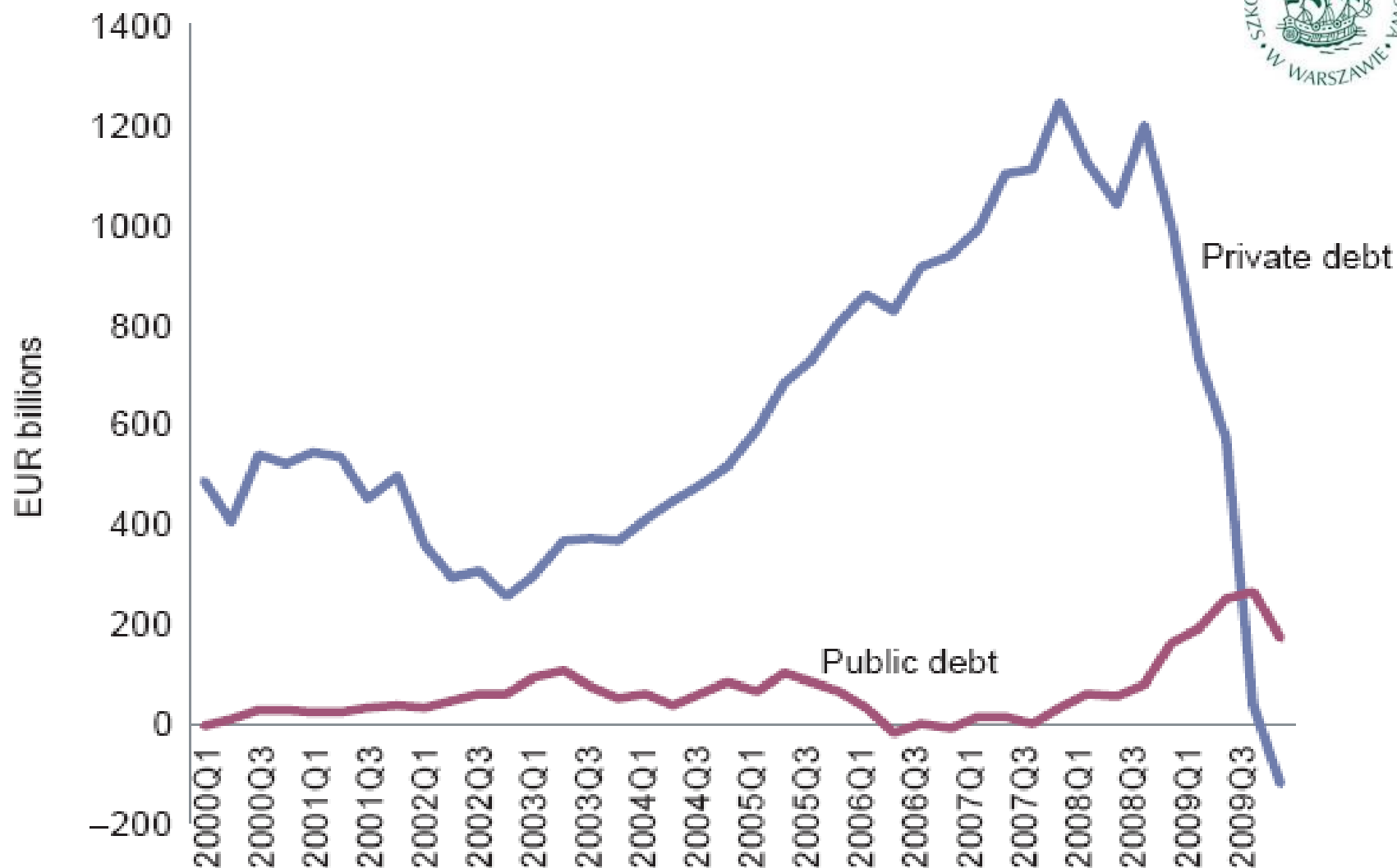
# 6

## The European Banking Union: A sanctuary for TBTF banks?



**Who should be blamed for the crisis:  
irresponsible governments of irresponsible bankers?**

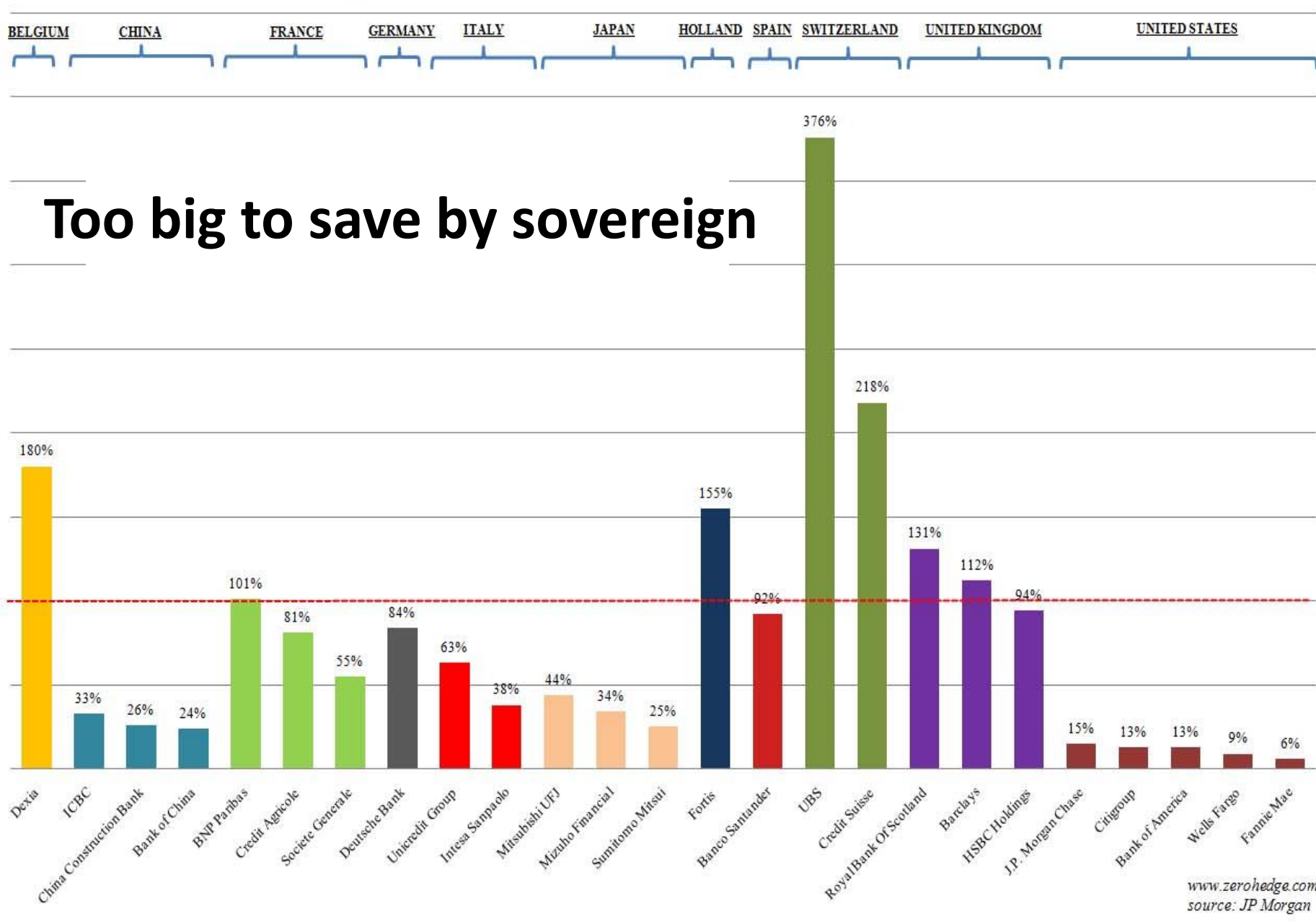
## Eurozone private and public debt



Source: ECB (moving average of first difference over four quarters).

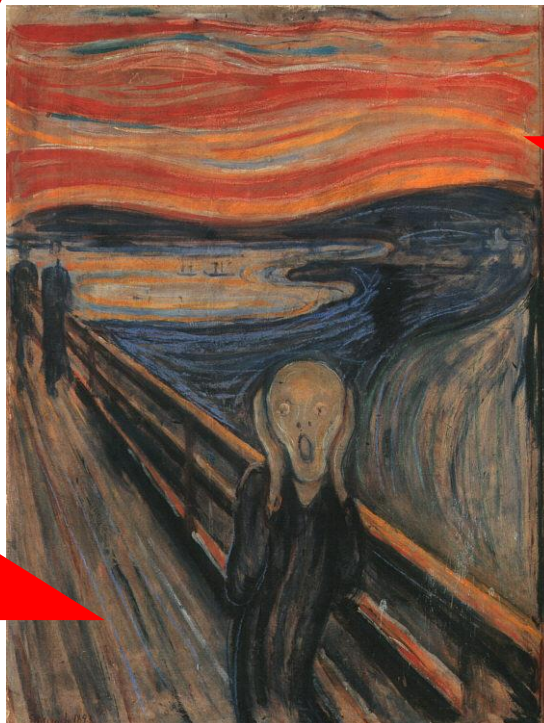
## Top 25 Global Banks: Total Assets To Home Country GDP

Too big to save by sovereign



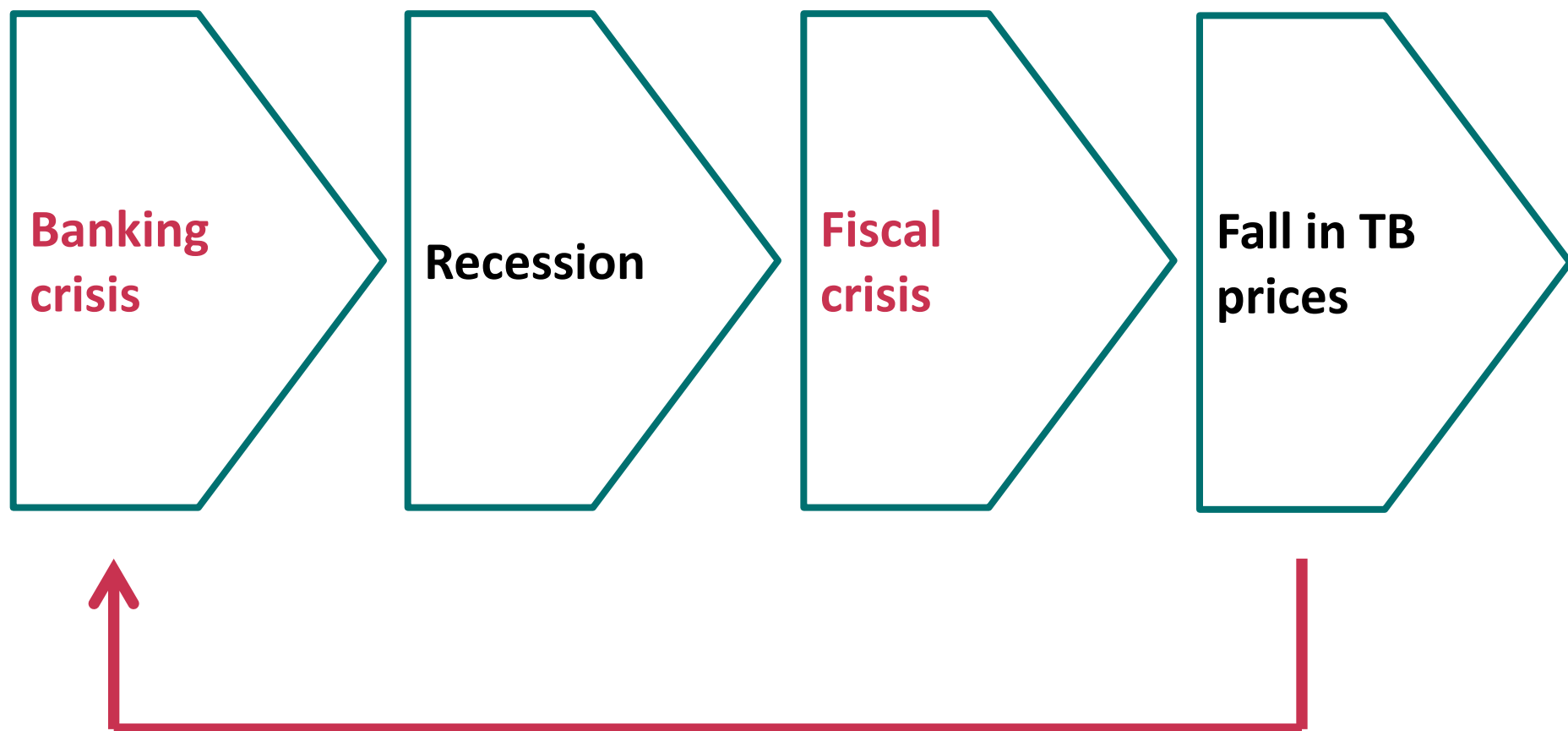
www.zerohedge.com  
source: JP Morgan

**Banking crisis**

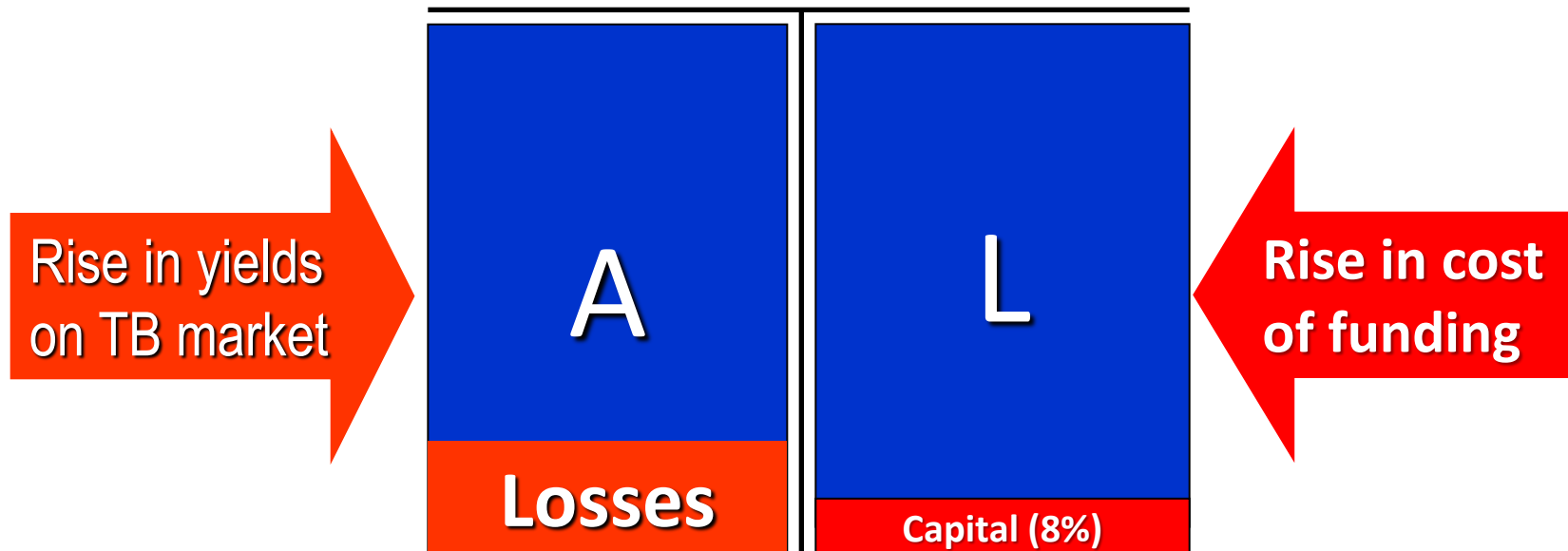


**Sovereign debt crisis**

# Diabolic loop

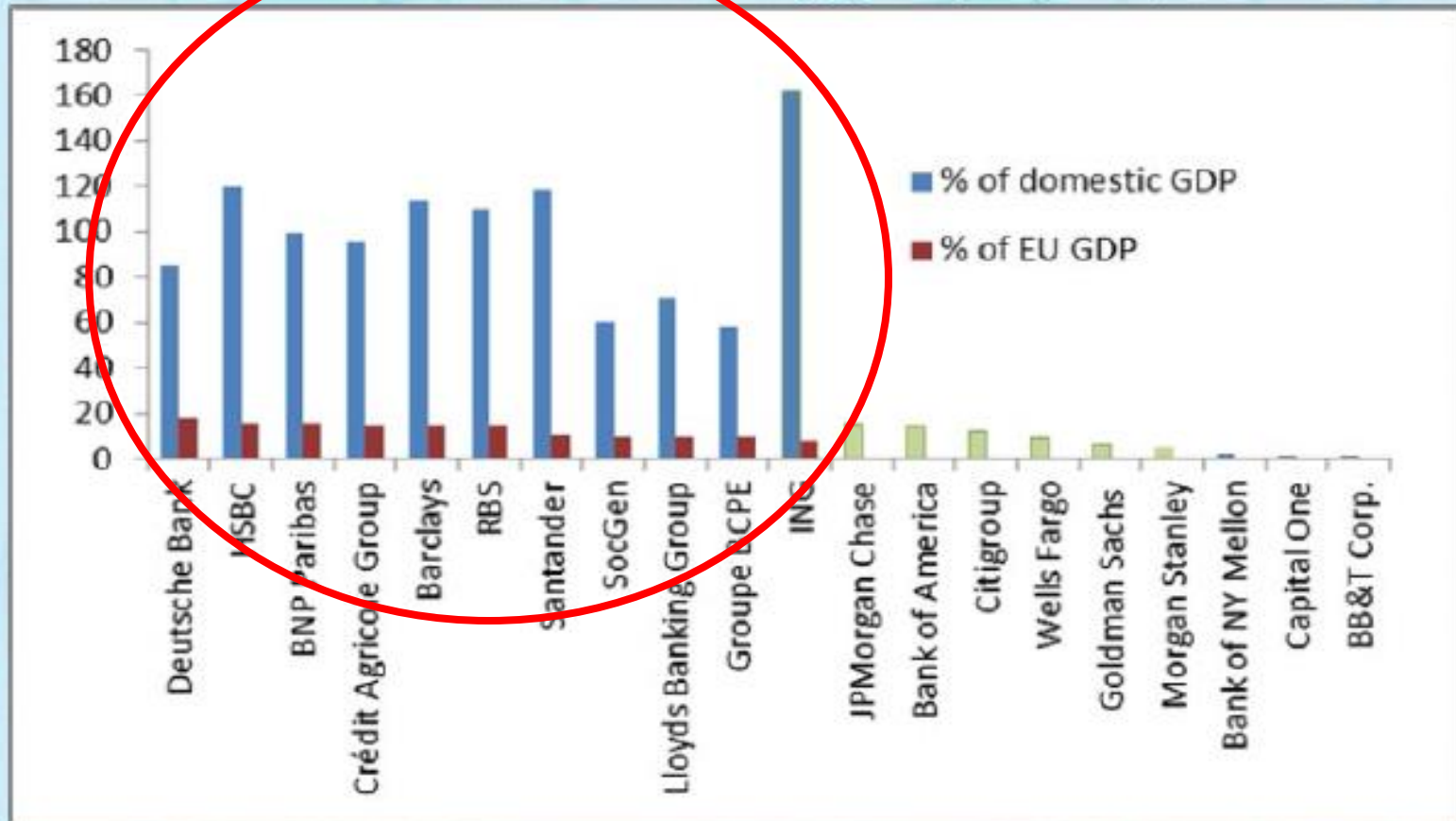


## Banks' balance sheets



# EU bank assets are sizable compared to home country GDP

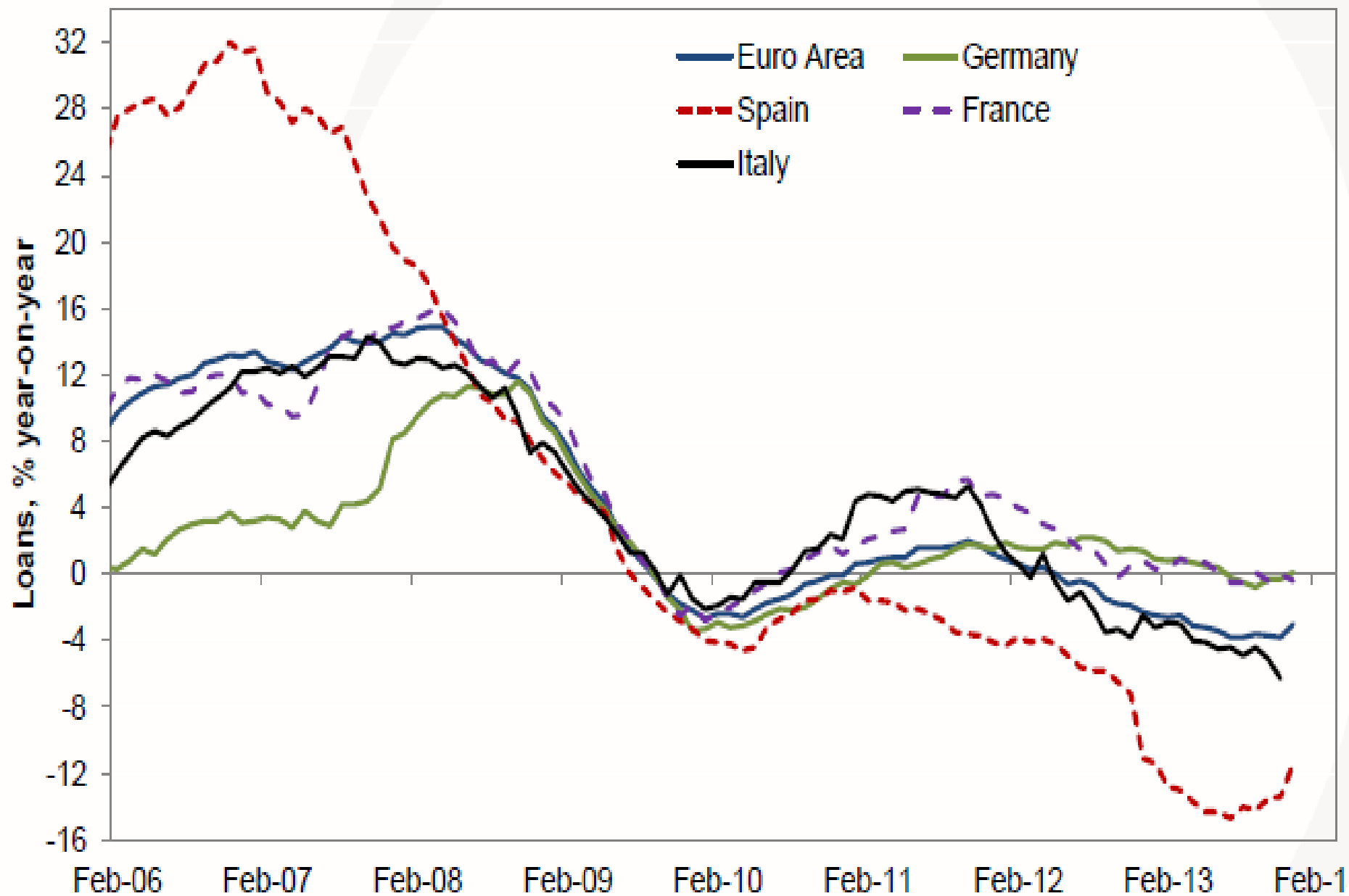
Total assets of EU and US banking groups (2011, in % of GDP)



Source: Data from SNL Financial. Eurostat for GDP data as presented in High-level Expert Group Final Report

Erkki Liikanen, "Is a reform of banking necessary?", speech, Finance Watch, Brussels, 20 November 2012

- „Banking union may prove ineffectual because equity cannot be injected into weak banks or be used to tackle past losses, and could not be used without a sovereign guarantee. This means the **risks** of such an exercise **still lie fully with the sovereign**” (Kapoor, Goodhart 2013)



**Why do Europeans cherish  
their large international banks?**

- „I am convinced that **financial integration** in Europe promotes political integration.”
- „**You, the financial market** actors, **can** also **help** to make greater financial integration, higher growth and advanced **political unity** in Europe a reality”.

Gertrude Tumpel-Gugerell, „Single market for financial services – vision or reality?”. Luxemburg Financial Market Forum 2005, Luxemburg, 14 October 2005.

- „Large cross-border financial institutions are part of a broader financial and political project,
- as in case of the European Union, where pan-European banks are seen as a key driver of economic integration”.

Eleni Tsingou, „Too Big to Fail?” [in] *The Warwick Commission on International Financial Reform: In Praise of Unleveled Playing Fields*, The Warwick Commission, The University of Warwick, 2009.



*Alvin H. Hansen*

## The American Economic Review

Vol. XXIX

MARCH, 1939

No. 1, PART I

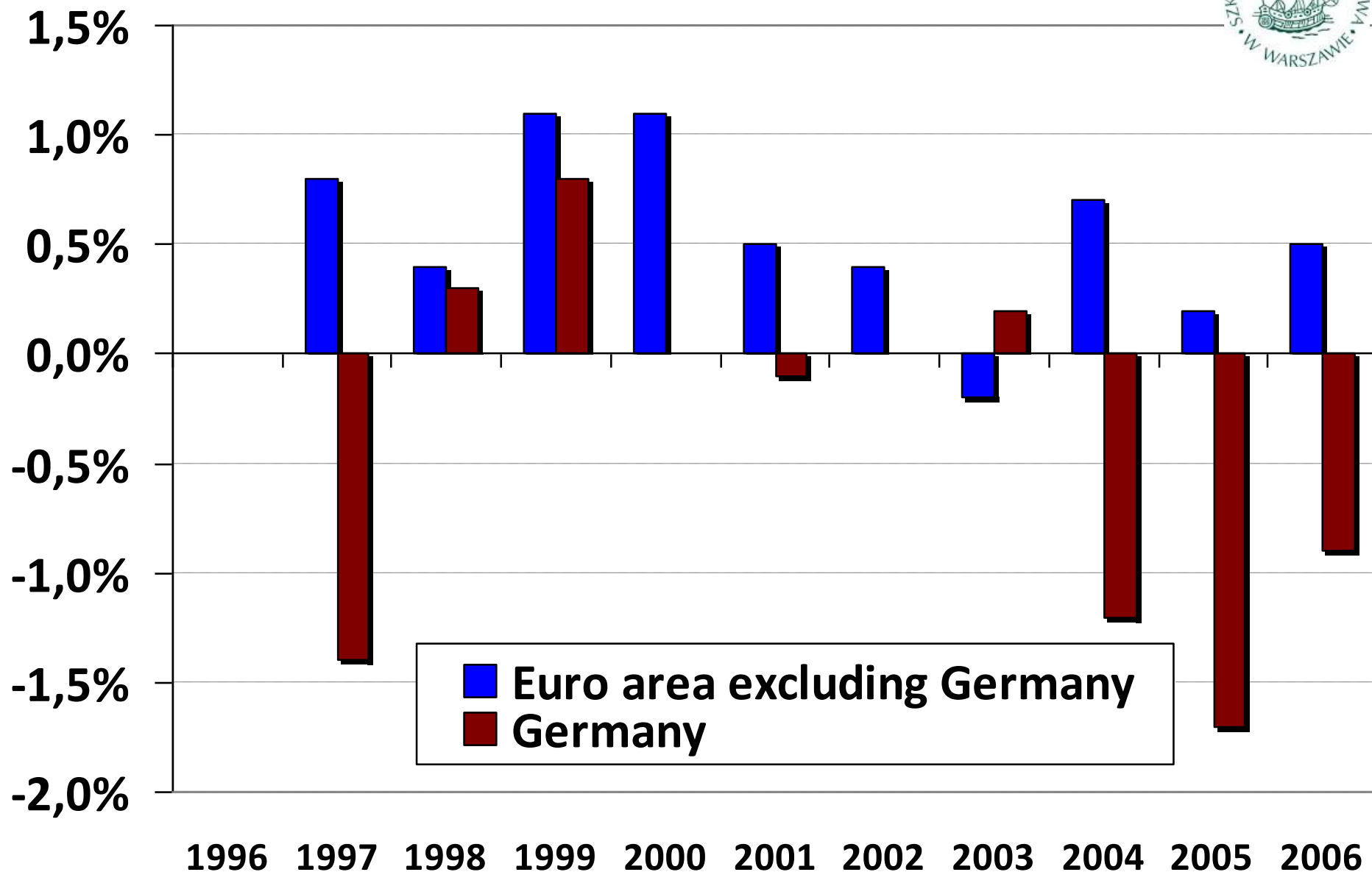
ECONOMIC PROGRESS AND DECLINING  
POPULATION GROWTH

Presidential address delivered at the Fifty-first Annual Meeting of the American Economic Association, Detroit, Michigan, December 28, 1938.

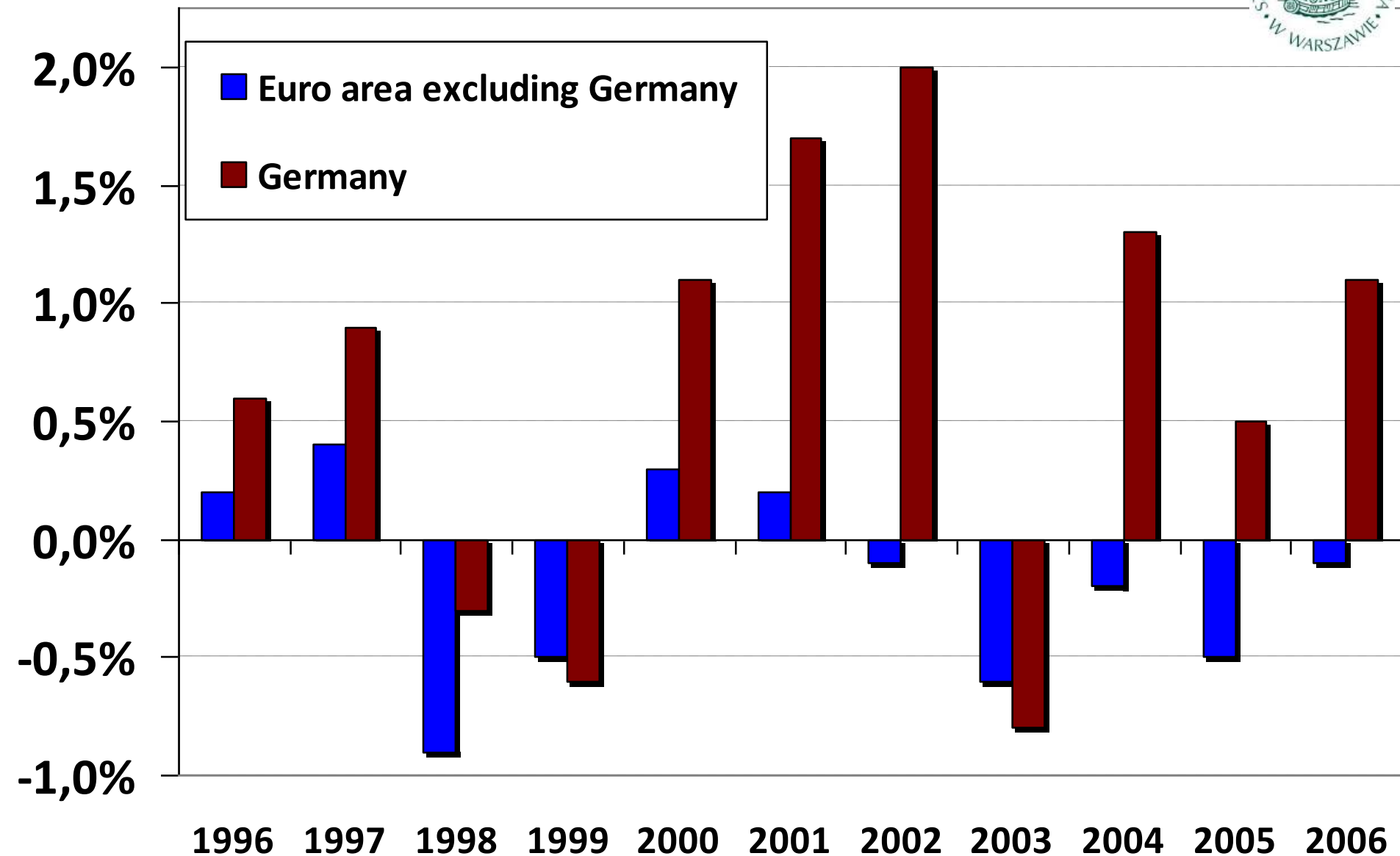
**Why does German economy fly on one engine?**



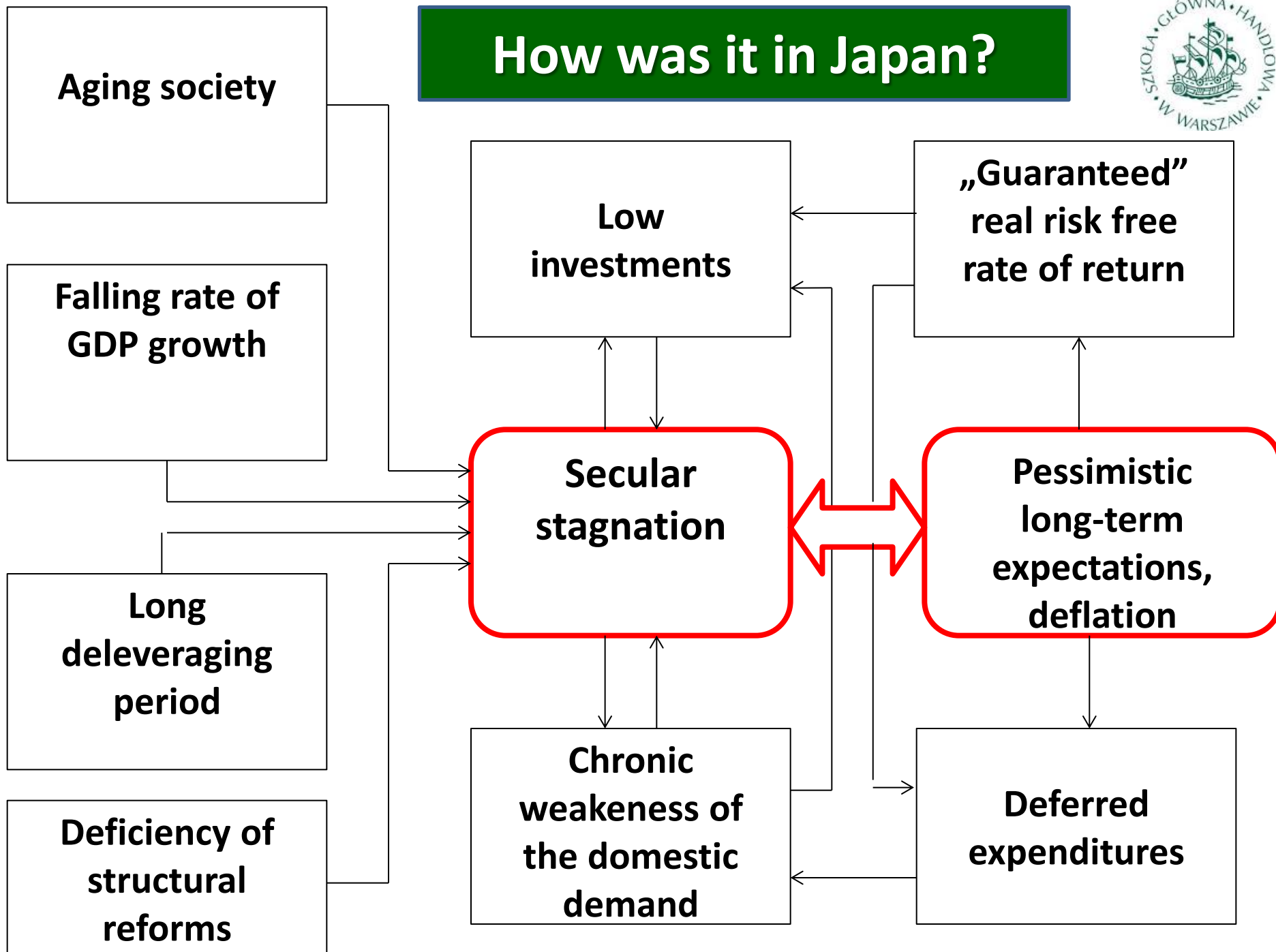
## Per capita growth in real wages



# Contribution of net exports to GDP growth

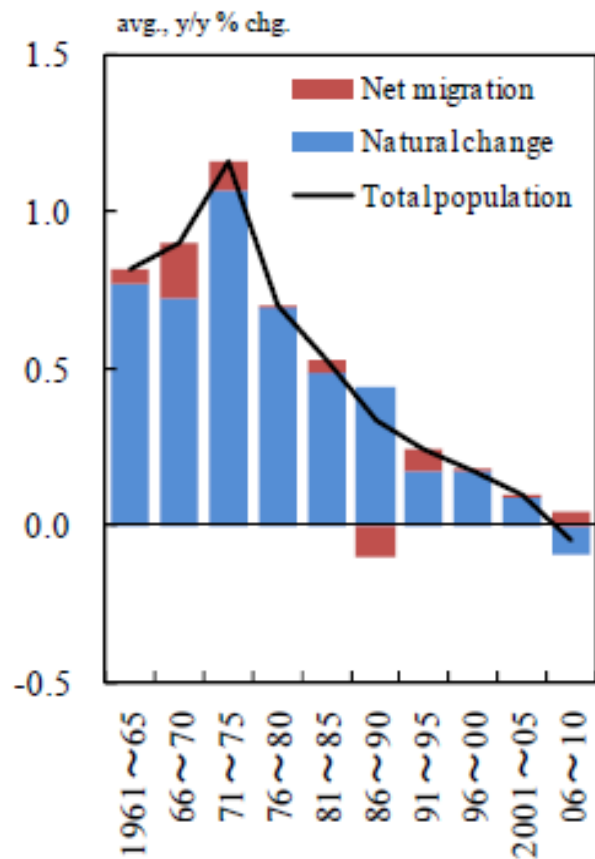


# How was it in Japan?

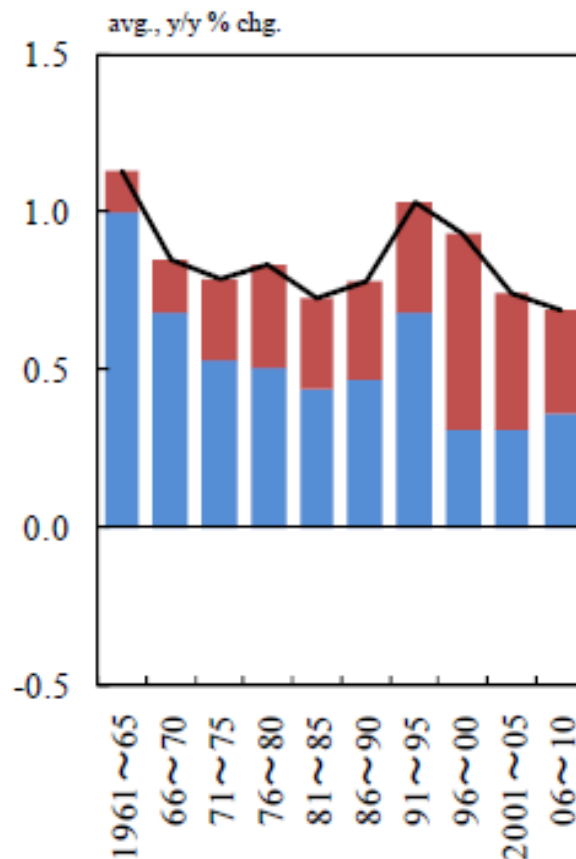


# Population Growth Rate

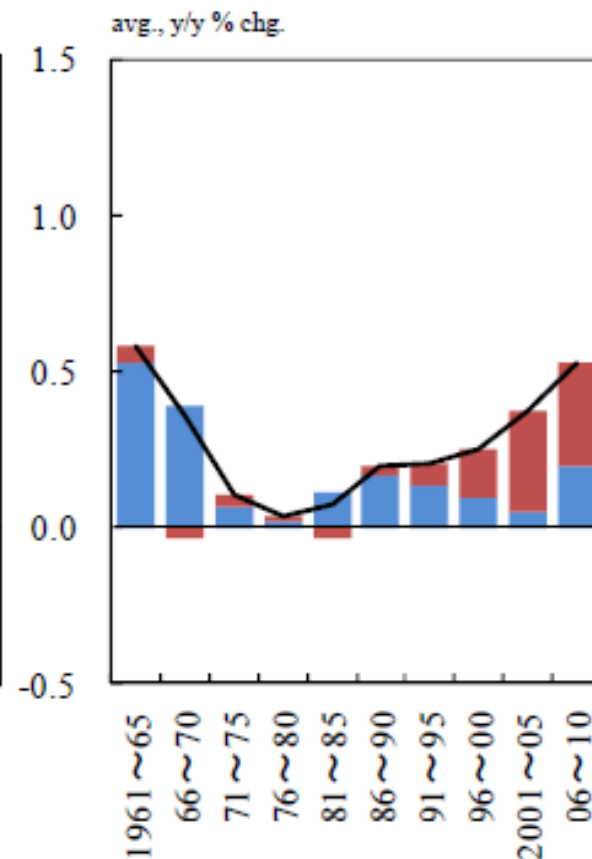
Japan



United States



United Kingdom

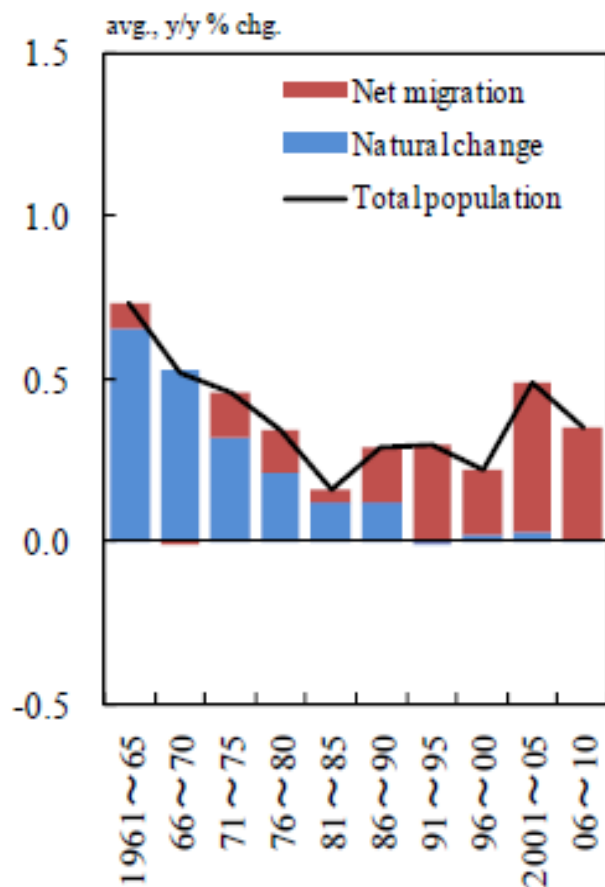


Source: World Bank.

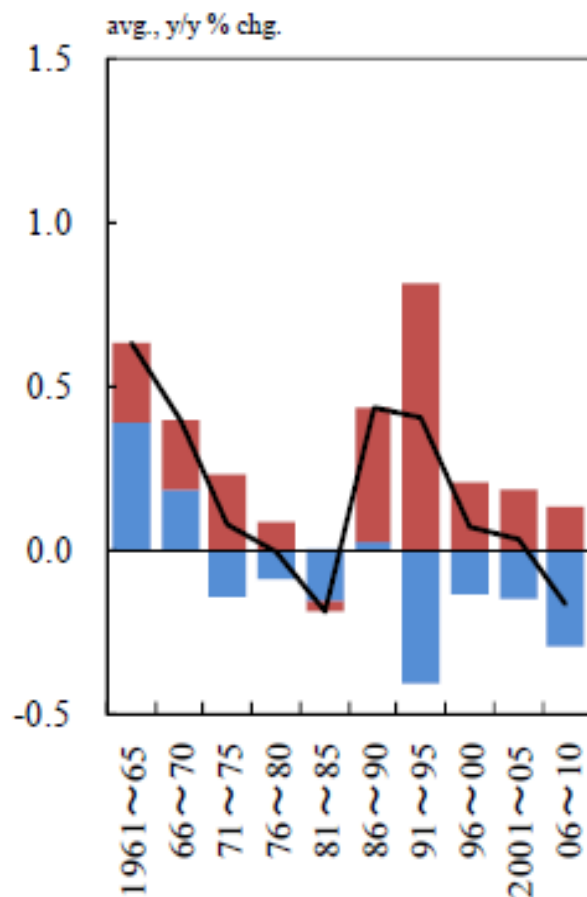
# Population Growth Rate (Cont.)



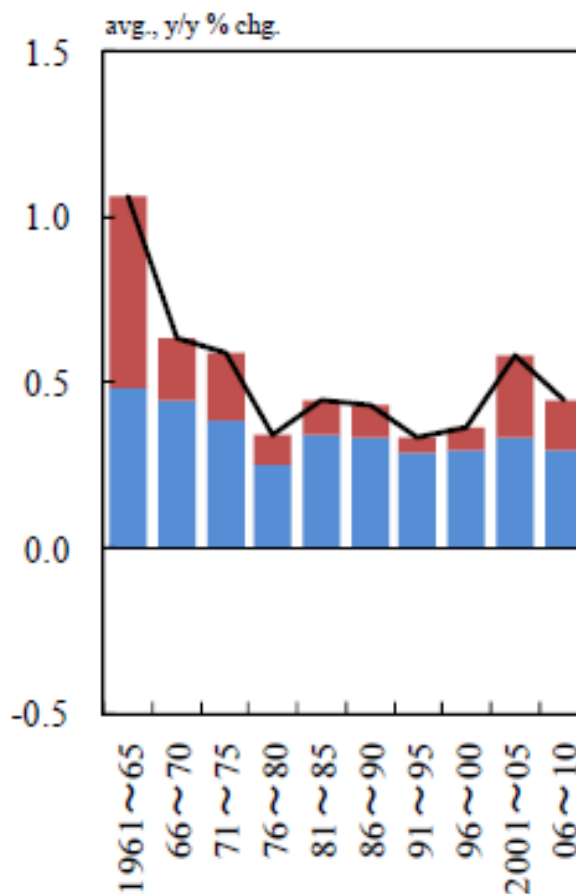
Euro Area



Germany

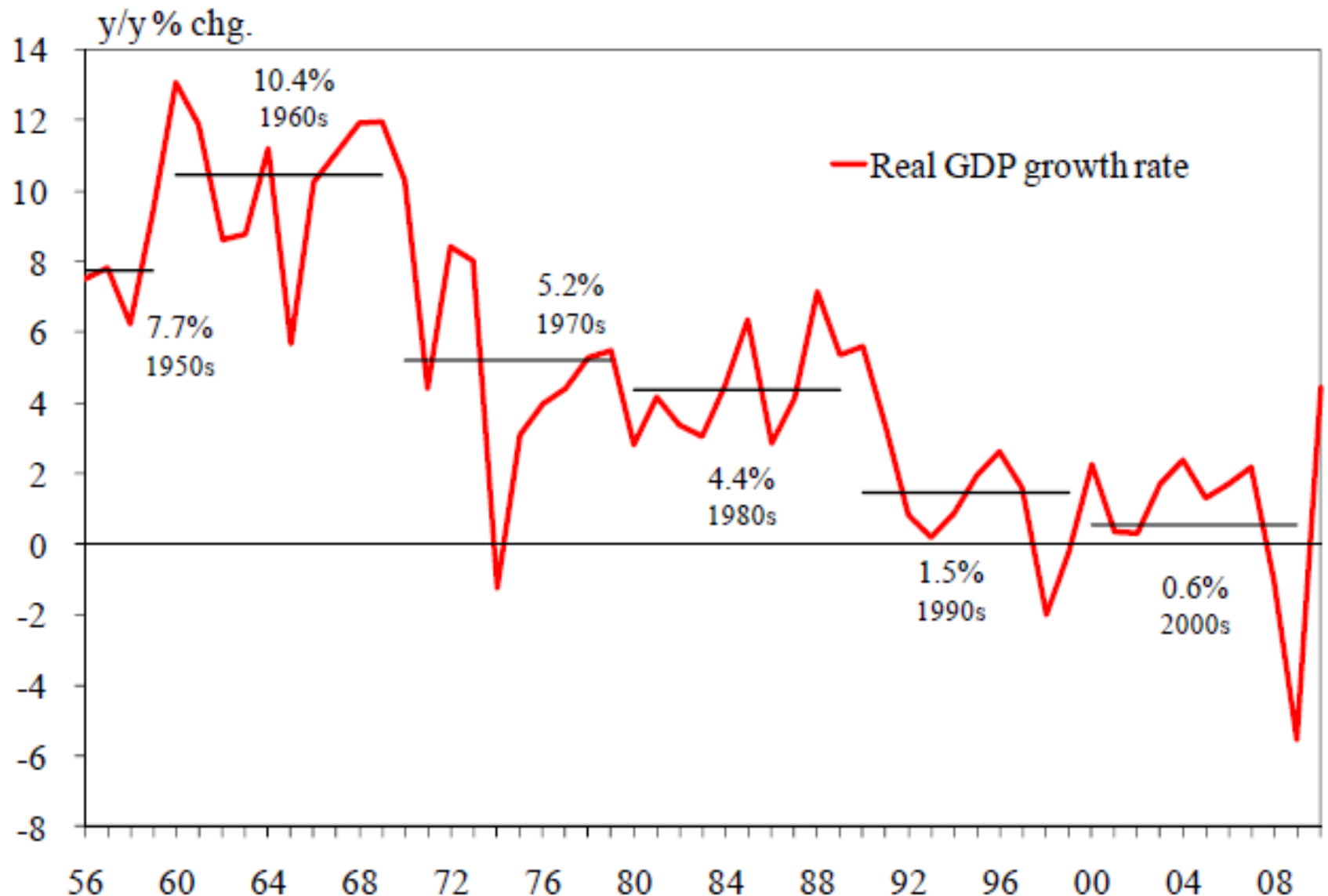


France

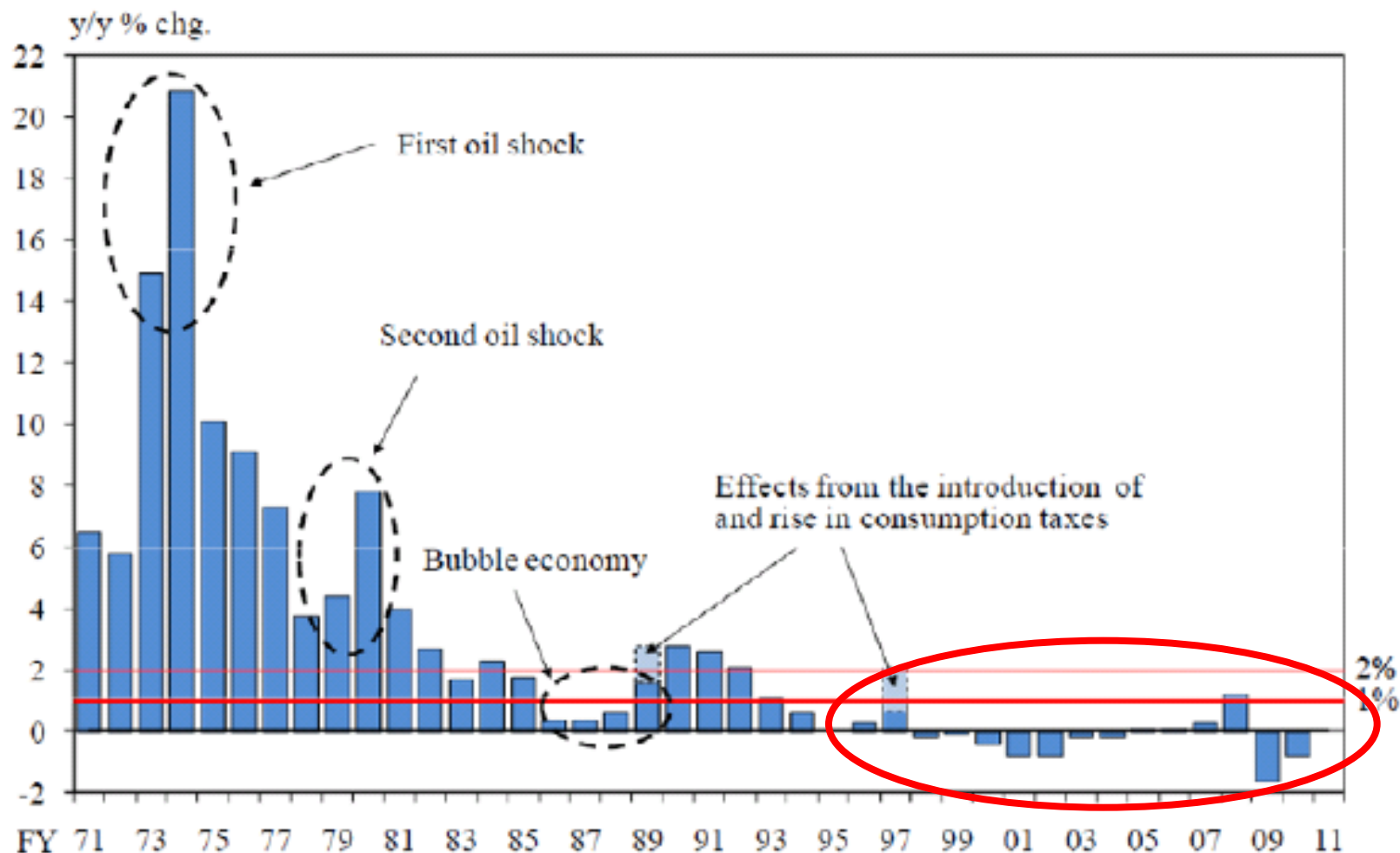


Source: World Bank.

# Japan's Real Economic Growth Rate in a Long-Term Horizon

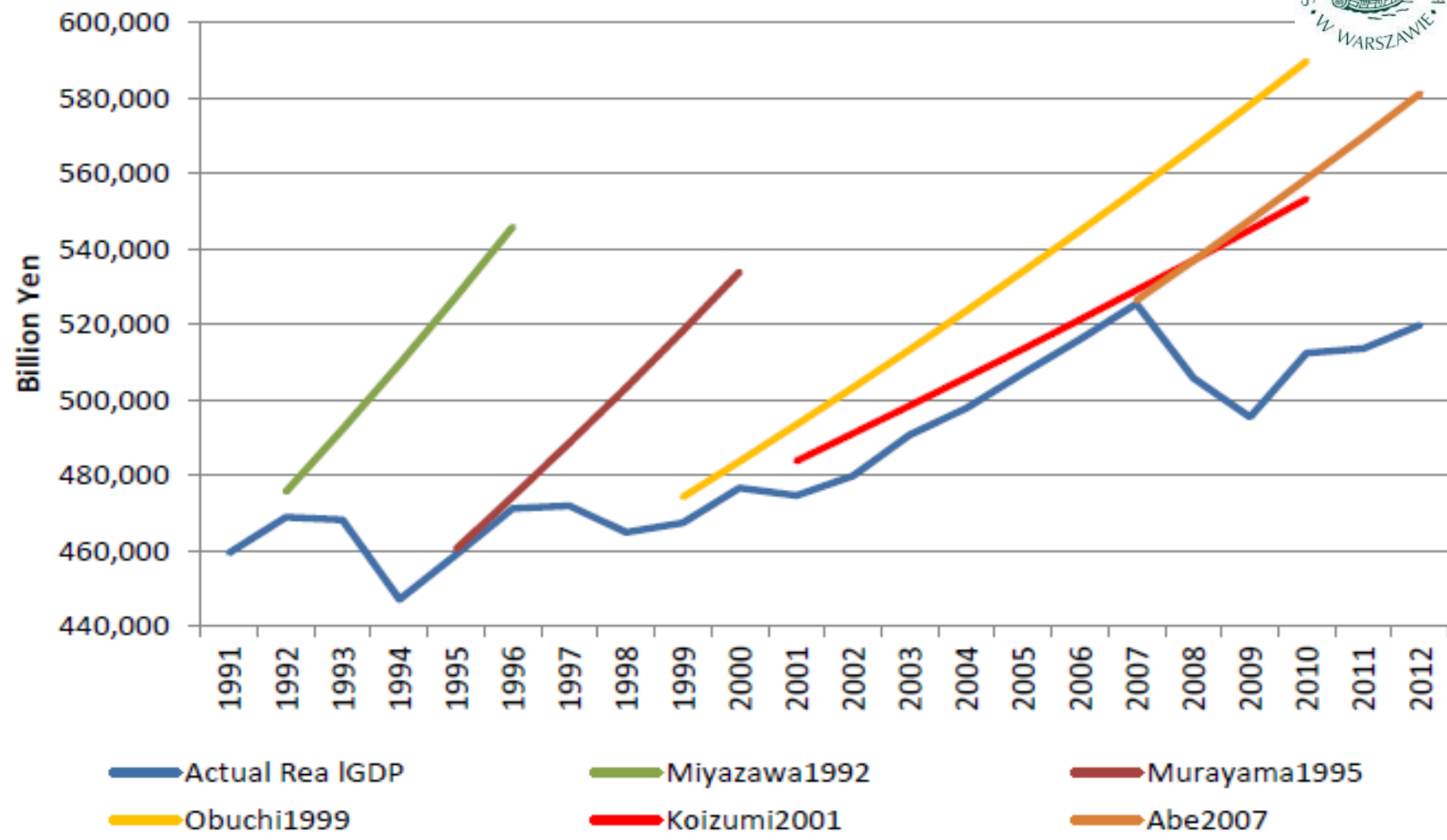


## Changes in Japan's CPI



Masaaki Shirakawa, „Japan's economy and monetary policy", Speech, Research Institute Of Japan, 4 June 2014

**Figure 6. Government Growth Forecasts**

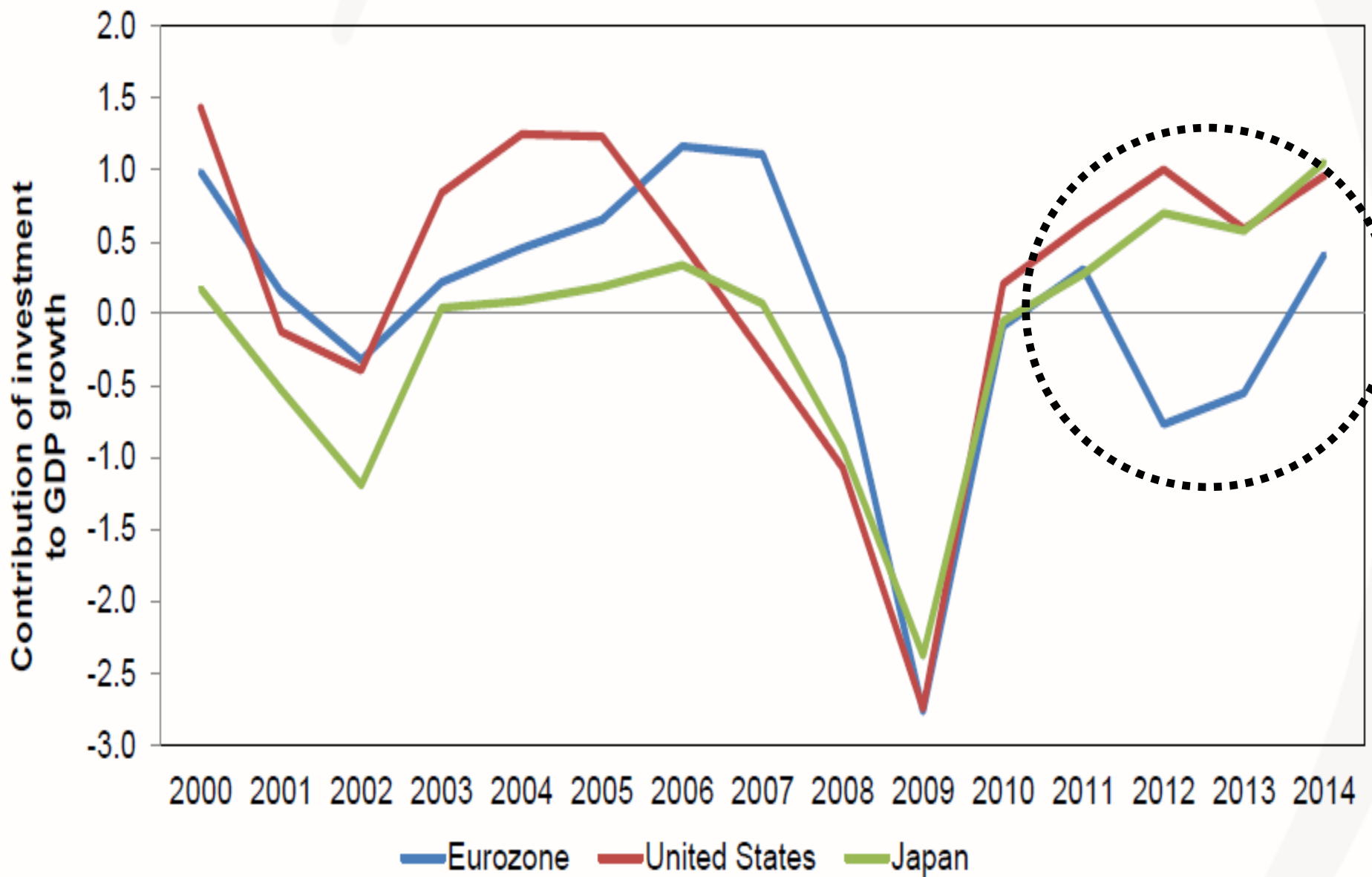


Takeo Hoshi, Anil K. Kashyap (2013) Will the US and Europe Avoid a Lost Decade? Lessons from Japan's Post Crisis Experience, 14th Jacques Polak Annual Research Conference, 7-8 November

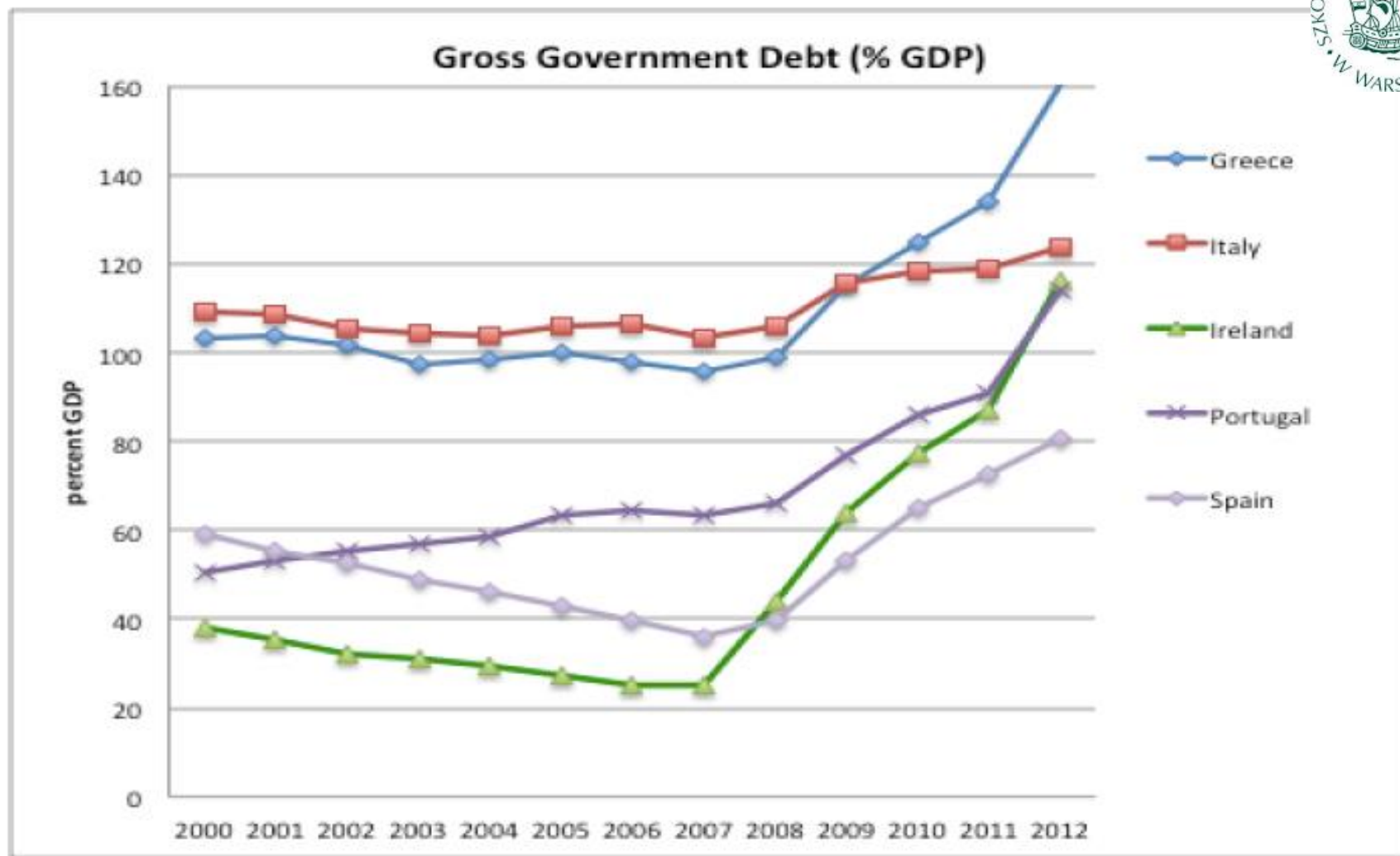
# What might create a euro-specific deflationary bias ?



- High debt to GDP ratios in peripheral countries
- Necessity of internal devaluations without transfers
- Asymmetric distribution of the costs of adjustments
- Deconvergence



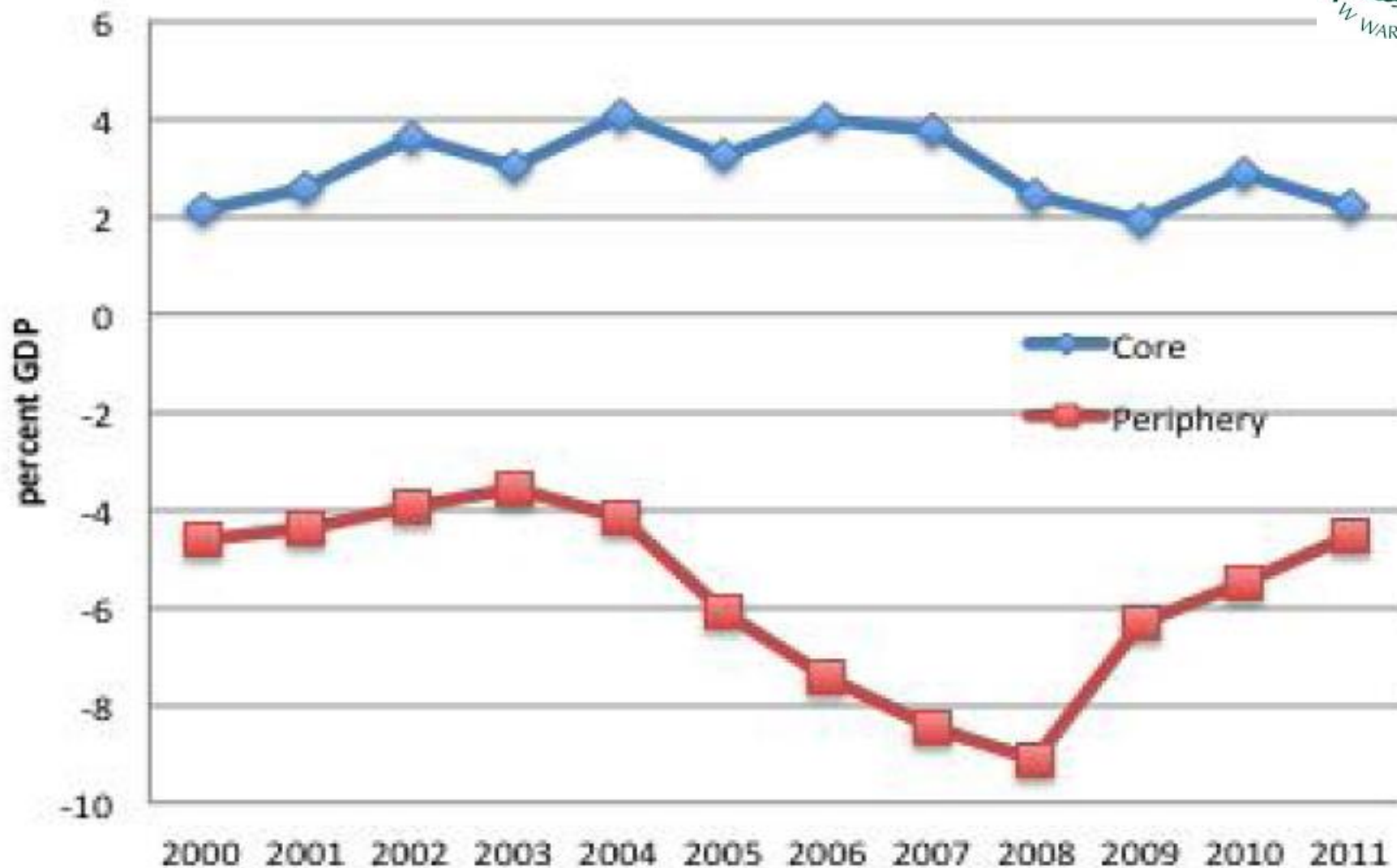
Source: Eurostat.



Source: European Commission, AMECO

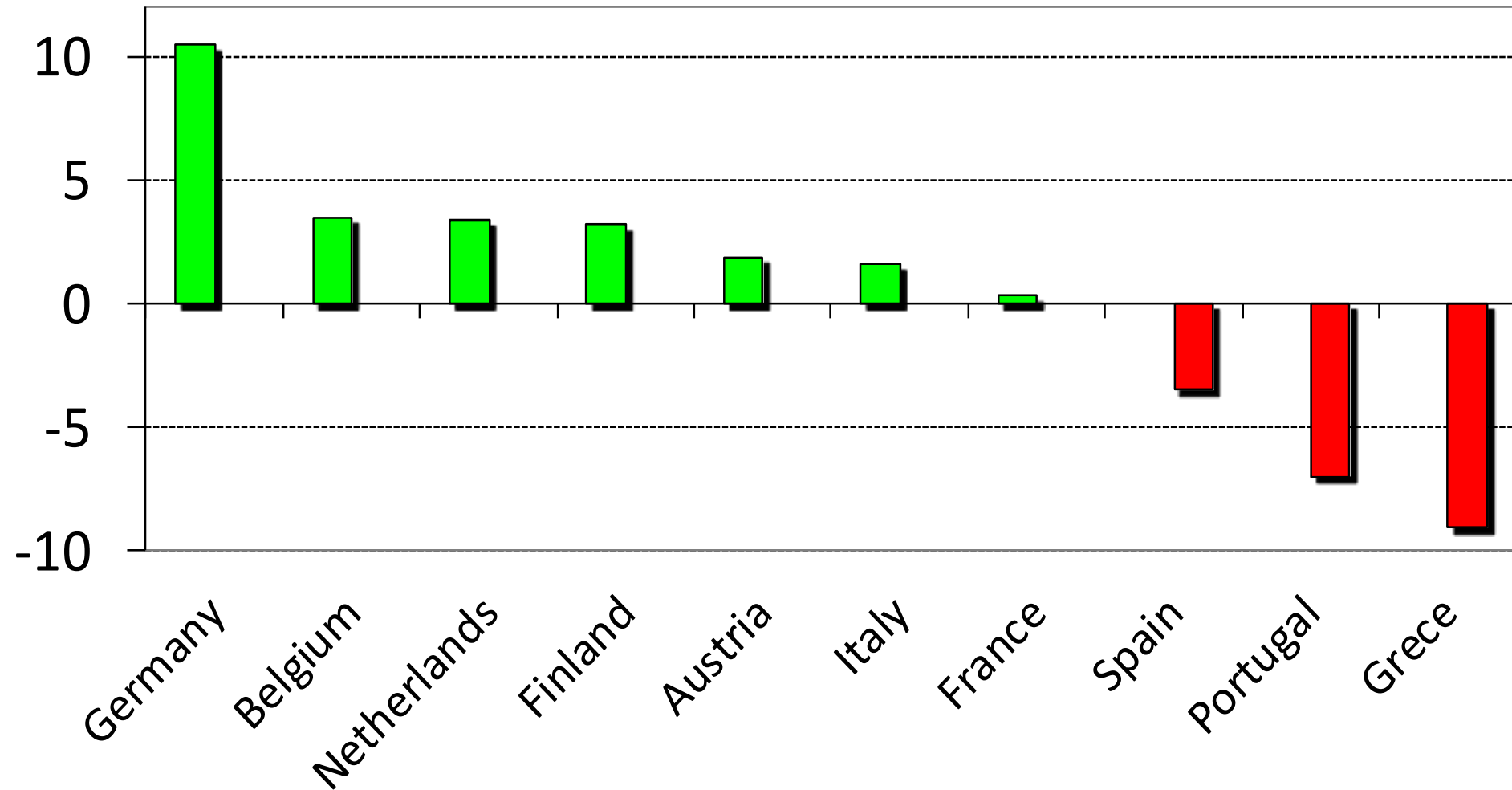
Paul De Grauwe, Design Failures in the Eurozone – can they be fixed? Economic Papers, no. 491, April 2013

## Current account surpluses (deficits) in Eurozone



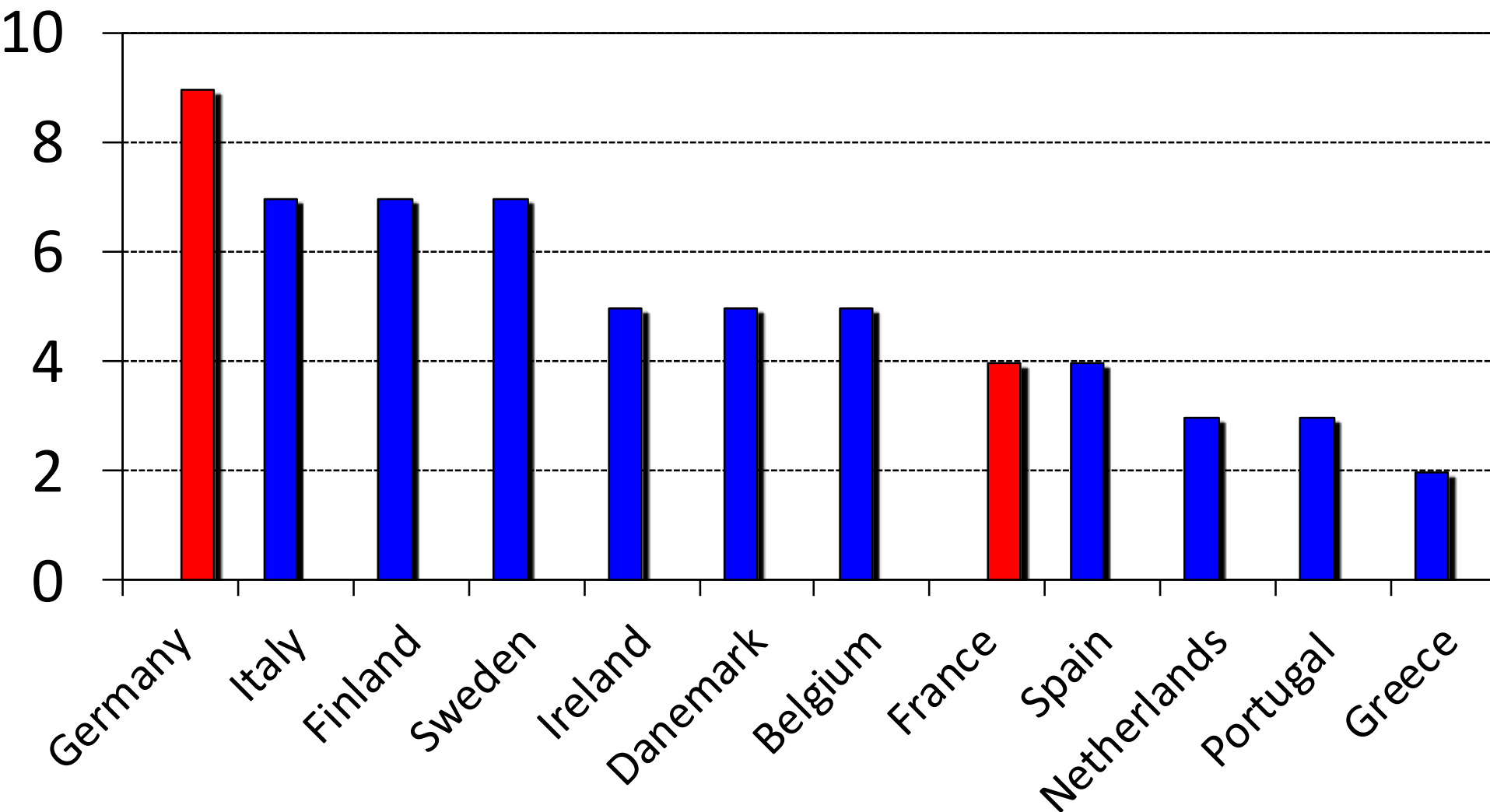
Paul De Grauwe (2012), "How to avoid a double-dip recession in the eurozone"  
CEPS Commentary, 15 November

# Net exports of knowledge-intensive manufacturing (2008, percent of GDP)



*Trading myths: Addressing misconceptions about trade, jobs, and competitiveness,  
Mc Kinsey Global Institute, 2012*

## Employment in knowledge-intensive manufacturing (percent of overall employment)



*Trading myths: Addressing misconceptions about trade, jobs, and competitiveness,  
Mc Kinsey Global Institute, 2012*

**„In labor mobility and wage flexibility we trust”**



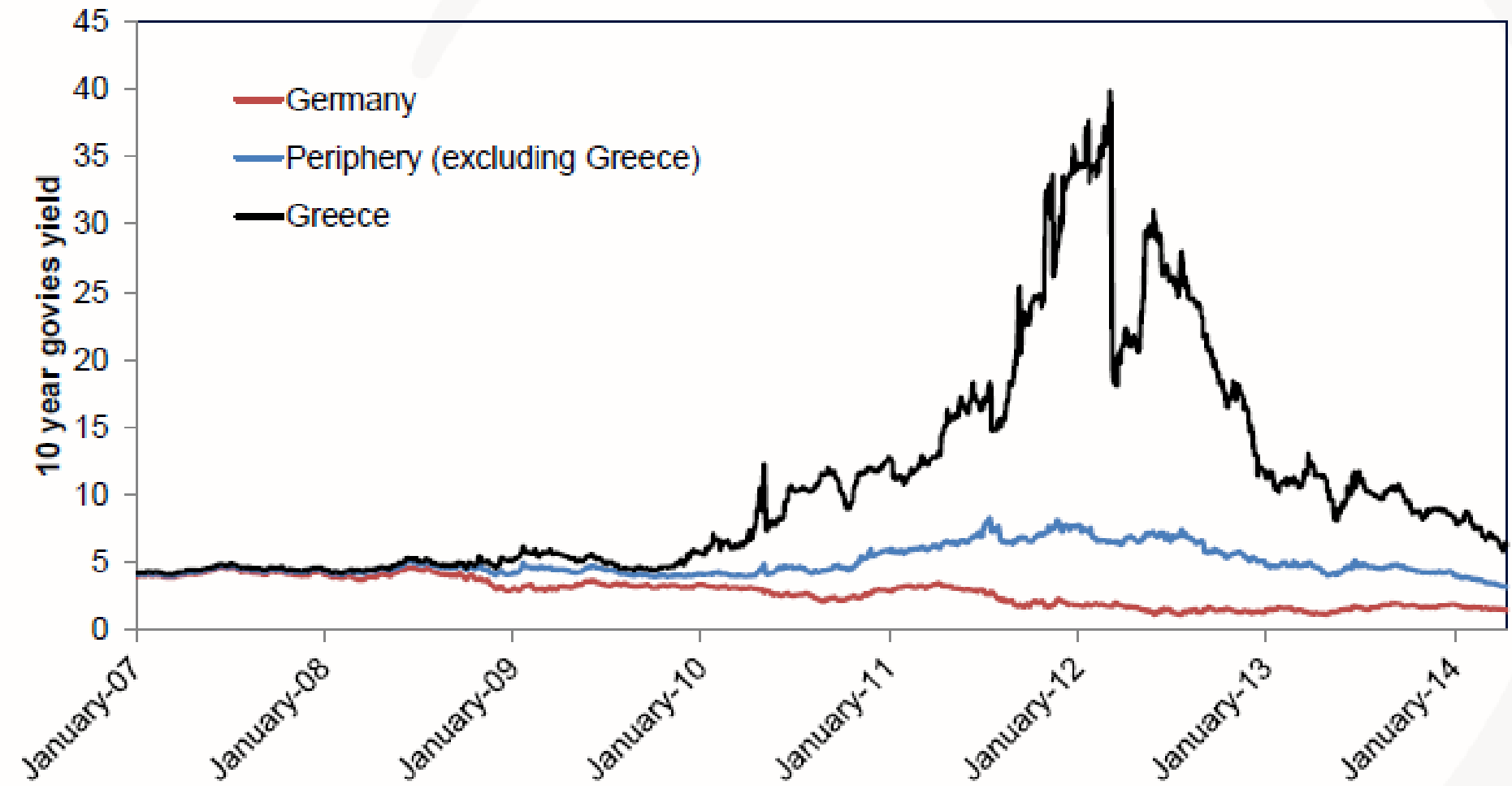
# 8

## The future of the Eurozone: A task for generations?



<http://www.service800inc.com/blog/bid/43611/The-customer-satisfaction-feedback-data-dam-is-leaking>

## Market confidence almost restored: interest rates are converging

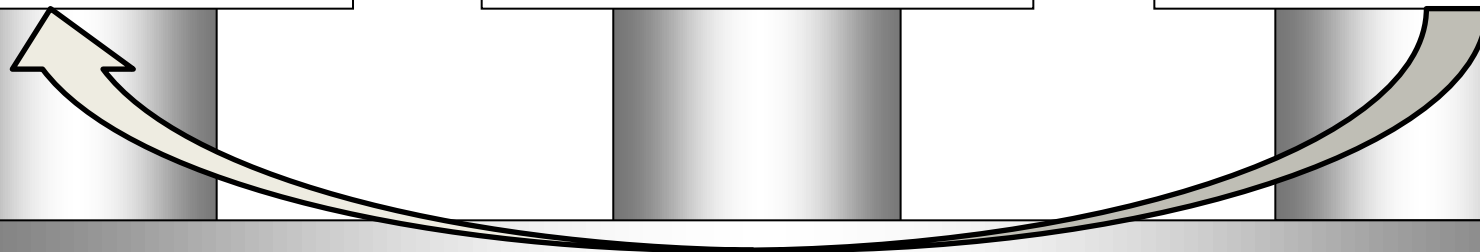


# Finishing the Eurozone edifice

Fiscal union:  
Without  
redistribution  
of income?

Banking union:  
Resolution  
of the TBTF?

Political union:  
???



- „Chancellor Angela Merkel’s government **agreed to** underwrite the debt of Germany’s states, backing a form of burden-sharing **that she is resisting at the euro-area** level to combat the financial crisis”.

Bloomberg 25 June 2012

- „Look what happened when Chancellor Merkel insisted that the rescue of the banks should be the responsibility of each country individually. In retrospect, that was the **first step in a process of disintegration**. (Soros 2014)

# THE FIRE CODE

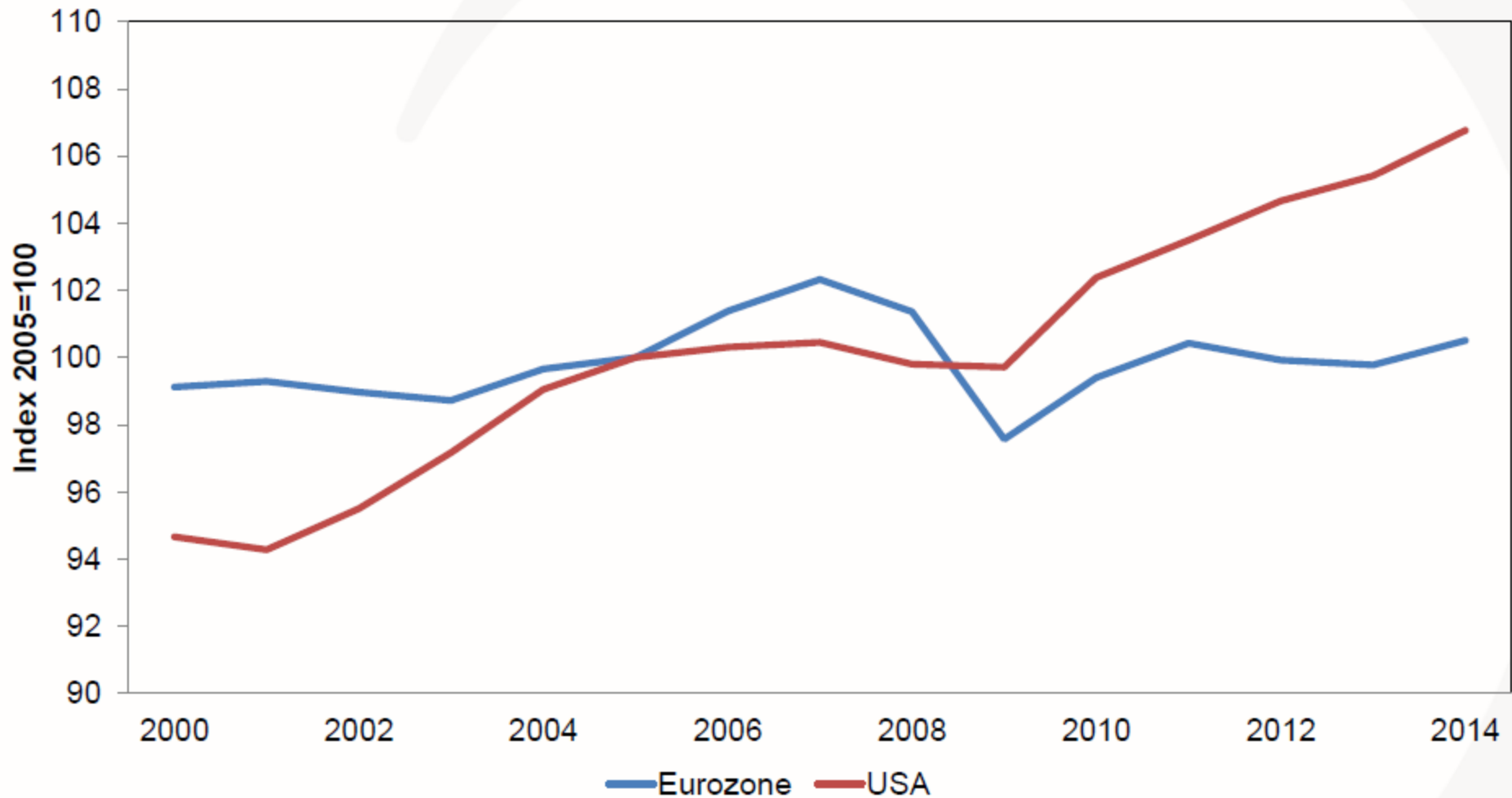
OFFICE OF THE FIRE MARSHAL

MINISTRY OF THE SOLICITOR GENERAL AND CORRECTIONAL SERVICES

- Eurozone still lacks a fire brigade
- and has to avoid the dominance of creditor-debtor relationships



## Weak growth of TFP in Europe



Source: Eurostat.

# Will the ESM evolve into a European Monetary Fund?



**Where are the keys to a long-term solution?**





*Thank you for your attention!*