Economic and Monetary Union and the Sovereign Debt Crisis

Lecture by Lex Hoogduin for the Masters Course European Union Studies of Leiden University, 23 February 2011, Den Haag

Thank you for inviting me to speak about European economic integration. Nout Wellink, the president of DNB, has lectured several times to your predecessors on this topic. Since his last lecture in 2009, a great deal has changed to the economic and political environment in which the EMU operates. After the financial crisis and the Great Recession, we are currently experiencing severe tensions in some of Europe's sovereign debt markets. At the root of these tensions, we find the combined effect of some individual euro area countries pursuing wrong policies and the failure of the system of mutual surveillance in the euro area, posing a number of challenges for the future of EMU.

But before turning to the European sovereign debt crisis, I take the opportunity today to look back on the historical context and the functioning of EMU so far, to see what has been achieved and what can be improved upon. In doing so, I use the economic theory of optimal currency areas. This theory clarifies that participating in a monetary union brings benefits in terms of eliminating exchange rate risks, but also entails costs as countries lose the shock-absorbing properties of flexible exchange rates and independent monetary policies. The benefits of eliminating exchange rate risk will be greater, the higher the level of interconnectedness, particularly through trade. The costs of losing the exchange rate and monetary policy as shock absorbers will be greater, the more countries are prone to asymmetric shocks and the weaker their alternative adjustment mechanisms are. Important alternative adjustment mechanisms which can compensate for the loss of monetary policy are labour mobility and wage, price or fiscal flexibility. I realise that this approach is not without limitations, since it denies the fact that the history of EMU lies in politics, rather than economics. Its largely political origin makes the creation of EMU, at least from a purely economic point of view, to a large extent an exogenous event. Nevertheless, the economic analysis of optimal currency areas does provide a useful yardstick to assess to what extent the functioning of EMU can further improve. My lecture this afternoon is divided in four parts: i) a short sketch of the history of EMU; ii) its achievements; iii) its weak spots, which led to the current sovereign debt crisis, and iv) the challenges ahead. Please feel free to ask questions as I go along and if something is not entirely clear. But perhaps we can leave general questions and the debate until the end. Then you can let me know whether or not I convinced you about the sustainability of the EMU.

Short history of European economic and monetary integration

As I said earlier, political factors rather than economic ones have played the dominant role behind the creation of EMU. The nations of Europe share a remarkable cultural heritage in philosophy, politics, science, religion and arts. Advanced thinkers have long recognised that this common heritage might serve as a basis for the formation of a political entity. Such an entity could affect world events more effectively than nations separately. But the most important motivation behind European economic integration has been the desire to avoid future intra-European conflicts. From Napoleon to Bismarck to the Kaiser to Hitler, Franco-German conflicts were flash points for continent-wide and worldwide wars. European integration holds the promise of binding the economic interests of these and other European states so closely, to make future intra-European conflict unthinkable.

With this argument in mind, the Treaty of Rome was concluded in 1957. In this treaty, European states committed themselves to economic integration in the form of a common market. This implied free movement of goods, services, capital and labour. The so-called European Economic Community, like the current European Union, was based on communal decision-making. Member countries partly transferred their decision-making powers to supranational institutions like the European Commission. The hope of policymakers was to create a virtuous circle, in which closer economic integration promotes greater political stability, and vice versa. Since then, the process of European integration has advanced in ups and downs. In the 1960s, trade tariffs were slashed rapidly, and as a result mutual trade between countries increased significantly. Then the process stalled, and it was not until 1986 that the European project was put back on track with the Internal Market programme. The Internal Market was not fully completed until 1999. In that year, economic integration reached its peak with the introduction of EMU, and its single currency the euro.

The key characteristic of the EMU is the existence of a single monetary policy combined with national responsibilities for fiscal, structural and supervisory policies. The objective of the single monetary policy is to keep inflation close to, but below 2% in the medium term. Although the other macroeconomic policies remain national, the Stability and Growth Pact explicitly limits the room for national autonomy in the fiscal area: it calls for budgets that are close to balance or in surplus over the cycle, deficits below 3% of GDP and a public debt level of below 60% of GDP. The Pact was created for two reasons: firstly to prevent unsustainable national policies from frustrating the single monetary policy and secondly to allow automatic fiscal stabilisers to work fully, given the importance of fiscal policy as an alternative adjustment mechanism in the absence of national monetary policy. With regard to the other alternative adjustment mechanisms, it was implicitly expected that the creation of EMU would, through competition, more or less automatically lead to more convergence and more flexible labour and goods markets, in line with the view that an optimal currency area is partly endogenous. For European central bankers, these are the rules of the game as defined by the political authorities. It is not our job to set these preconditions for EMU, but to explain their consequences to politicians and the general public.

<u>The achievements of EMU</u>

The economic achievements of EMU are not easy to quantify. What matters in the end is of course the welfare of all European citizens. Ideally one would like to have an estimate of their welfare with and without the currency union. As a proxy, I shall review a few developments in a number of areas that are positively associated with increased welfare from EMU.

First of all, the EMU has delivered price stability. Notably, the structure and mandate of the European Central Bank (ECB), as well as the perception of continuity with policies of the pre-euro Bondsman, have enhanced the ECB's credibility and contributed to low and stable inflation in the euro area. The average annual inflation rate in the euro area since the introduction of the currency was 1.97%. By comparison, the average annual rate of inflation in Germany in the 1990s, before the euro was introduced, was 2.2%. In the 1980s, the rate was 2.9%, in the 1970s 4.9%. In other words, in terms of price stability, the euro does not need to shy away from any comparison with the Deutsche Mark.

Let me now turn to the goods market. Having a common currency has eliminated exchange rate risks within the euro area and has increased price transparency across borders. These factors have led to positive effects on trade within the euro area over and above the positive effects generated by the continuing process of EU integration in a single market. In this respect, the view that optimal currency areas are endogenous was proven correct, as the creation of EMU has stimulated trade. Yet, estimates on the size of the effect have provided very heterogeneous results, largely due to the adoption of different methodologies of analysis. Economists now seem to have reached the consensus view that the single currency has boosted the growth of euro area countries' trade on average by 2 to 3 percentage points. This is consistent with the fact that since 1998 euro area trade growth with Denmark, Sweden and the United Kingdom has been on average around 3 percentage points lower than trade growth within the euro area.

In addition to stimulating trade, the euro has strengthened the European financial markets, by stimulating integration and thereby efficiency. Traditionally, the efficiency and scope of these markets has been hampered by the costs and risks associated with the use of multiple currencies as well as by the fragmentation arising from international differences in legal structure, accounting rules and other transaction costs. Given the speed and high frequency of transactions in financial markets, even small transaction costs can hinder the efficiency and liquidity of those markets. The euro has significantly reduced those transaction costs, thereby improving the breadth and efficiency of European financial markets. At the same time, unfortunately, financial markets failed to differentiate sufficiently between euro area countries with different risks, which brings me to the third part of my lecture today: the weak spots of EMU, leading to the European sovereign debt crisis.

<u>The weak spots of EMU: Origins of the European sovereign debt crisis</u>

With the introduction of the euro, the process of European integration has been given further impetus. While this has produced tangible results in terms of growing welfare, by increasing macroeconomic stability and further trade and financial integration, the sovereign debt crisis clearly demonstrates that the job is not complete. Most importantly, alternative adjustment mechanisms to compensate for the loss of exchange rate flexibility and national monetary policy have worked inadequately. I will first discuss these mechanisms in a general way, before turning to the specifics of the sovereign debt crisis.

Budgetary policy was supposed to absorb temporary cyclical differences, by allowing the automatic stabilisers to do their work. For example, public spending automatically goes up when more people receive unemployment benefits, while revenues from taxes decrease during a downturn. The ‘automatic’ response to cyclical developments stabilises the economy. But in most member states the automatic stabilisers have worked incompletely since 1999. Instead, a number of governments followed pro-cyclical budgetary policies; they eased during the economic booms, and subsequently had to tighten during the bursts. In other words, budgetary policies have hampered the functioning of the EMU. When a few years ago it became clear that in some countries fiscal policies would not be able to meet the rules of the Stability and Growth Pact, it was not the policies that were changed but the Pact. This was clearly a mistake.

Labour mobility can also provide an alternative to monetary and exchange rate policies. Temporary or permanent migration of employees from member states with high to low unemployment can limit the negative welfare effects of asymmetric shocks for the EMU as a whole. However, in practice labour mobility between member states is persistently low, given the considerable differences in unemployment and wage levels. To a large extent this is due to language and cultural barriers, but also to institutional impediments, such as the mutual recognition of diplomas and the transfer of pension entitlements. In addition, low mobility is probably the result of generous social security systems in most member states, which reduce the incentive to look for a job abroad.

Flexible prices and wages can also be helpful in the event of an asymmetric shock. When wages and prices are sufficiently flexible, production will fall less sharply in case of a negative shock, partly because foreign demand will expand thanks to cheaper domestically produced goods and services. Whereas progress has been made in product market reform, especially the EMU's labour market needs more flexibility. This can help to improve the functioning of EMU not only by providing an alternative shock absorber, but also by helping to reduce growth and inflation differentials between member states. In the first case, the costs of joining EMU are reduced (as the loss of independent monetary and exchange rate policies is being compensated), and in the second case the advantages of the euro are enhanced (as the single monetary policy becomes more like a tailor-made suit instead of a straightjacket). In reforming the labour market, more weight should have been attached to increasing labour market participation, mobility and wage flexibility.

Turning to the sovereign debt crisis more specifically, it is first of all important to understand that this is not a crisis of the euro, but a crisis of individual euro area countries, pursuing wrong policies. Fiscal discipline and sound prudential supervision have been lacking. In addition, many national authorities failed to implement important reforms in the labour and product markets to make them more flexible and suited for the change of regime brought about by the adoption of the euro. The point I want to make is that these policies would also have been wrong even if these countries would still have had their national currencies. At the same time, they demonstrate the failure of the system of mutual surveillance in the euro area. Let me elaborate on these two points.

The imbalances which have accumulated over the last few years in the euro area are the result of a combination of "good" and "bad" convergence. The so-called good convergence concerns the levels of per capita income. At the start of EMU the per capita income levels between countries differed significantly. It was to be expected that catching-up countries like Greece and Spain would experience faster economic growth. On average, between 1999 and 2008 per capita GDP increased at a yearly pace of 3.4% in Greece, 3.4% in Ireland and 2.0% in Spain, much higher than the average for the euro area (1.4%), which was broadly similar to that of the US (1.5%).

The "bad" convergence I referred to was the speed at which income increased in the catching-up countries, which largely took place through debt, either public or private. As a result, their debt with the rest of the world increased tremendously over the past decade. The most dramatic development took place in Ireland, which moved from a net creditor position of 52% of GDP in 1999 to a net debtor position of 71% of GDP in 2008. Greece increased its net debtor position from 33% to 76% of GDP; Portugal from 32% to 96% and Spain from 28% to 79%.

The expectation of higher levels of income led to excessive consumption and investment compared with the supply capacity of the economy. As a result, cost and price increases exceeded productivity gains. The divergences in nominal developments were fuelled by four pro-cyclical factors:

- First, low interest rates, especially in real terms, encouraged risk-taking behaviour;
- Second, fiscal policies assessed on the basis of nominal variables (deficit as a percentage of GDP) were pro-cyclical and contributed to excessive domestic demand growth and the accumulation of external imbalances;
- Third, supervisory policies in many countries did not counteract excessive risk-taking and the related excessive credit growth, which fuelled a housing boom and/or an overheating process;
- Fourth, financial markets and rating agencies failed to differentiate sufficiently between euro area countries with different risks, contributing to the significant compression of risk premia in the sovereign debt securities markets. Ten-year government bonds were almost equally priced across all euro area countries between 2001 and 2007, while economic fundamentals continued to be very different.

The main point is that fiscal and structural policies need to keep domestic demand in line with rates of sustainable growth and price stability. Otherwise, booms and busts may prevail. This is sound policy advice for any country, since devaluation can only briefly restore competitiveness if cost and price increases are out of line with productivity growth. Being in a monetary union mainly means that the necessary correction of unsustainable economic policies cannot be postponed for too long. It is clear now that Europe relied too much on the view that optimal currency areas are endogenous, in the sense that entering a monetary union will enforce policy adjustment more or less automatically. Put differently, macroeconomic policies of some euro area countries have not adjusted enough to the economic reality of EMU, in which devaluation is no longer an option. Imbalances and vulnerabilities can and should be addressed by implementing, at the national level, much stronger fiscal discipline, better vigilance of financial developments and effective reform measures that deliver increasing productivity, competitiveness, employment and long-term growth. That brings me to the final part of my lecture, the action taken so far and the challenges ahead for the EMU.

Action taken so far and challenges ahead for the EMU

After the European sovereign debt crisis worsened in May 2010, European governments and the ECB have taken several steps to try to contain its impact, regain investor confidence and solve the underlying failures which led to the crisis. Governments have created the European Financial Stability Facility (EFSF), to provide – together with the IMF – crisis lending to euro area governments, based on strong conditionality. In Greece and Ireland, the adjustment towards a sustainable government debt path is currently being made with the help of an external financial assistance programme. In both countries the EU/IMF programme relies on very strong fiscal frontloading and comprehensive and far-reaching structural reforms which, in the case of Ireland, also include measures aimed at an overhaul of the banking sector. These programmes aim to correct the divergences which have accumulated over the past decade. Furthermore, governments have issued proposals to some strengthening of the system of fiscal and macroeconomic surveillance in the euro area. The ECB has addressed the severe tensions in financial markets by purchasing debt securities in certain market segments which are dysfunctional. The objective of this temporary Securities Markets Programme (SMP) is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism.

Currently, governments are working on a comprehensive package to address the crisis in a pro-active manner. Getting “in front of the crisis” would indeed be much more effective than following a peacemeal approach. At the same time, I think the decision to create a permanent European Stability Mechanism (ESM) to replace the EFSF was taken too hastily, as the implications for the functioning of EMU are not clear. That being said, the ESM is now a political reality. Within this ESM, the option of sovereign debt restructuring is explicitly mentioned. However, the restructuring of sovereign debt is a major event, with large confidence and potential contagion effects. It should therefore be considered only as an ultimate solution, when there are no other options left. To prevent the perception that European sovereign debt can be restructured more easily than the debt of other countries, it is vital that the established IMF practices are followed when it comes to crisis lending and debt restructuring. To this end, the IMF should be fully involved with any crisis lending to and debt sustainability analysis of euro area countries.

Taking a step back from the current discussions on the EFSF and the ESM, what is really needed to safeguard the sustainability of EMU in my view? Some say a single currency is viable only if there is a full fiscal union or even a political union. Although I agree that a political union would certainly solve the problem, I do not think it is necessary. I think it would be enough if the rules of the game were respected, as they were originally intended when the EMU was designed. This does call for some major changes with regard to the governance of individual euro area countries and of the euro area as a whole. Most importantly, national policies need to be adjusted and national policy frameworks need to be reformed as to guarantee sound and sustainable policy decisions. This reflects the fact that the European sovereign debt crisis has its roots in national policy failures. It also reflects the fact that the huge adjustment costs are mainly borne by the residents of the countries involved. Secondly, given the large potential spill-overs of national policy failures to the rest of the euro area, the system of mutual surveillance in the euro area needs to be strengthened rigorously. The steps taken so far are not enough and both fiscal and macro-economic surveillance have to be strengthened further, for instance through more automaticity and less political interference in preventing and correcting unsustainable fiscal policies. In that way, national autonomy would only be restricted by “Europe” when a country has broken the rules of the game.

The recent proposals of Ms Merkel and Mr Sarkozy with regard to a “Competitiveness Pact” could be useful too, as long as such a Pact focuses on the right policies. There is nothing in the theory of optimal currency areas that calls for harmonising retirement ages and tax rates. Other parts of the proposals, such as banning automatic wage indexation, mutual recognition of diplomas and a legal limit to sovereign debt, can increase fiscal and labour market flexibility and labour mobility, thereby improving the alternative adjustment mechanisms.

If, and only if, the national and euro area governance failures have been corrected, as a very distant third, a permanent crisis resolution mechanism for the euro area could be useful. Given the complexity of solving a sovereign debt crisis in a monetary union with closely intertwined but autonomous countries, prevention remains infinitely better than the cure.

Concluding remarks

EMU has seen a number of successes: the introduction of a new currency for 330 million Europeans, the maintenance of price stability, low interest rates and significant progress in the integration of the goods and financial markets. These achievements are remarkable, considering that they have been realised in a relatively short period of time and in a unique political context. Indeed, Europe is the world's laboratory: we have created the first supranational political entity which is based on friendship rather than coercion and violence. We have fought each other for centuries, and now live in peace in Western-Europe for more than 65 years. This constitutes the longest uninterrupted period of peace in a millennium! I dare to say this is to a large extent because of closer economic and monetary integration. We may congratulate ourselves with this performance, but this is no the time for complacency. We have many challenges to cope with in the years to come. Some are shared with many other countries in the world, like restoring fiscal soundness and drawing all the right lessons from recent global financial crisis. Other challenges are specific to the euro area, like the further improvement of the single market with a single currency through structural reforms and improved governance. If the past 65 years are a compass for the future, I am optimistic we will find the right answers to our current challenges. Thank you for your attention. I would welcome any questions.