The Future of Europe: the Euro and Brexit

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The problem

- Eurozone has been ill-designed
- It will have to be redesigned to survive in the long run. How?
- Let me first explain the nature of these design failures.

Eurozone's design failures: in a nutshell

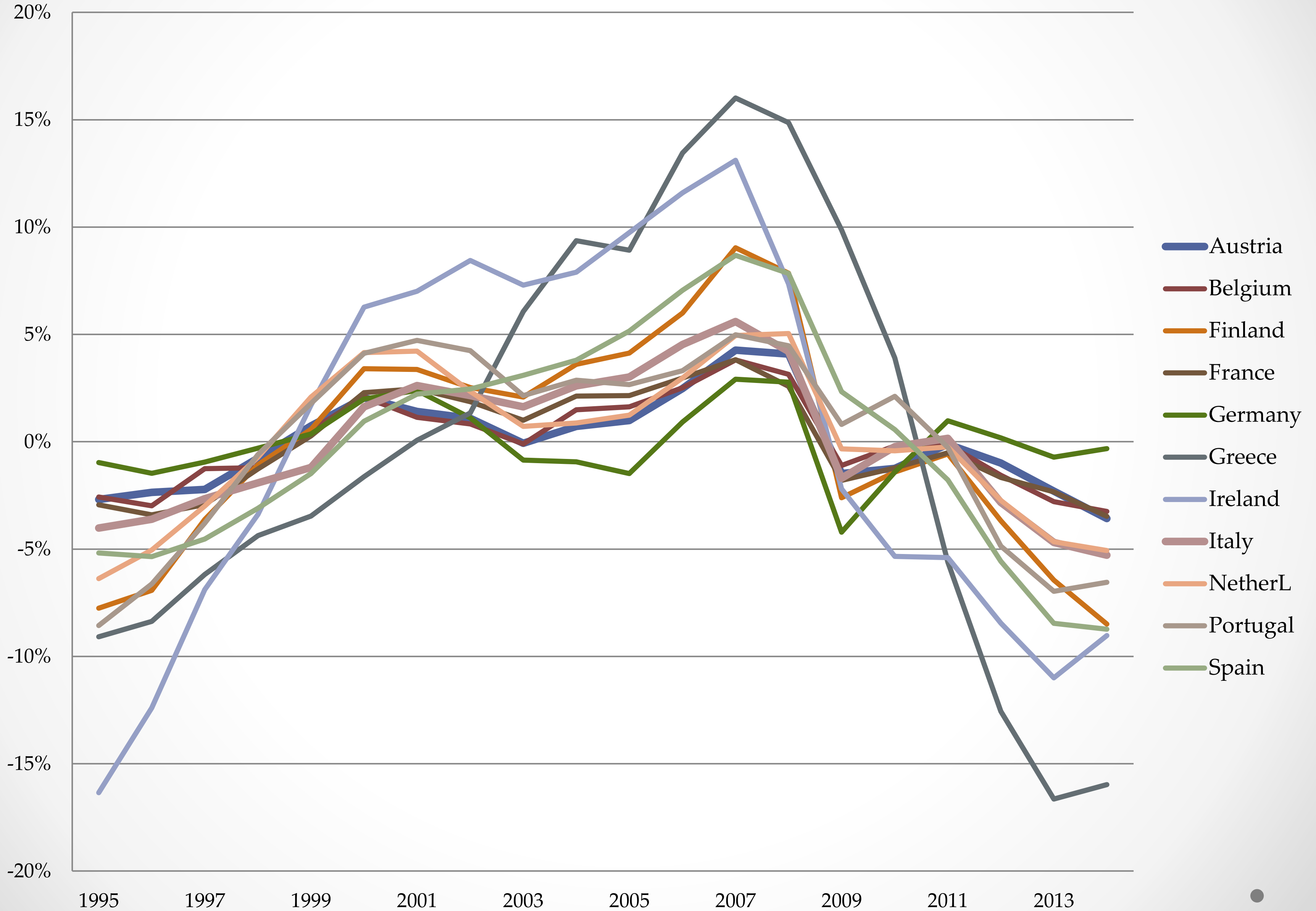
1. Dynamics of booms and busts are endemic in capitalism and continued during Eurozone,
   - triggering large divergent movements in competitiveness
   - while adjustment mechanisms are failing

2. Stabilizers that existed at national level were stripped away from the member-states without being transposed at the monetary union level.
   - This left the member states "naked" and fragile, unable to deal with the coming disturbances.

Let me expand on these points.

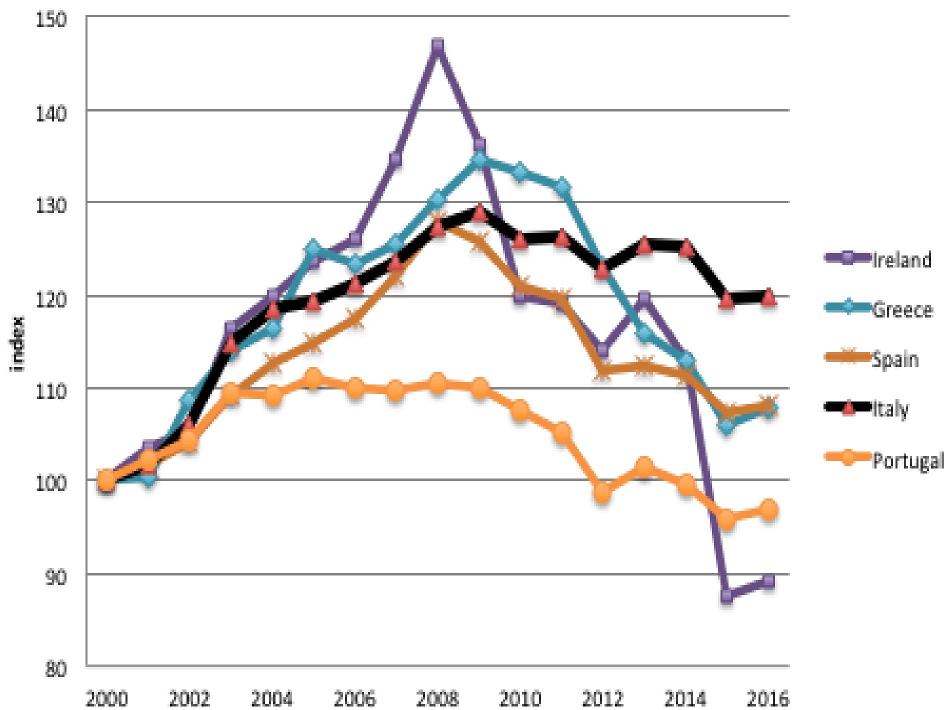
Booms and busts

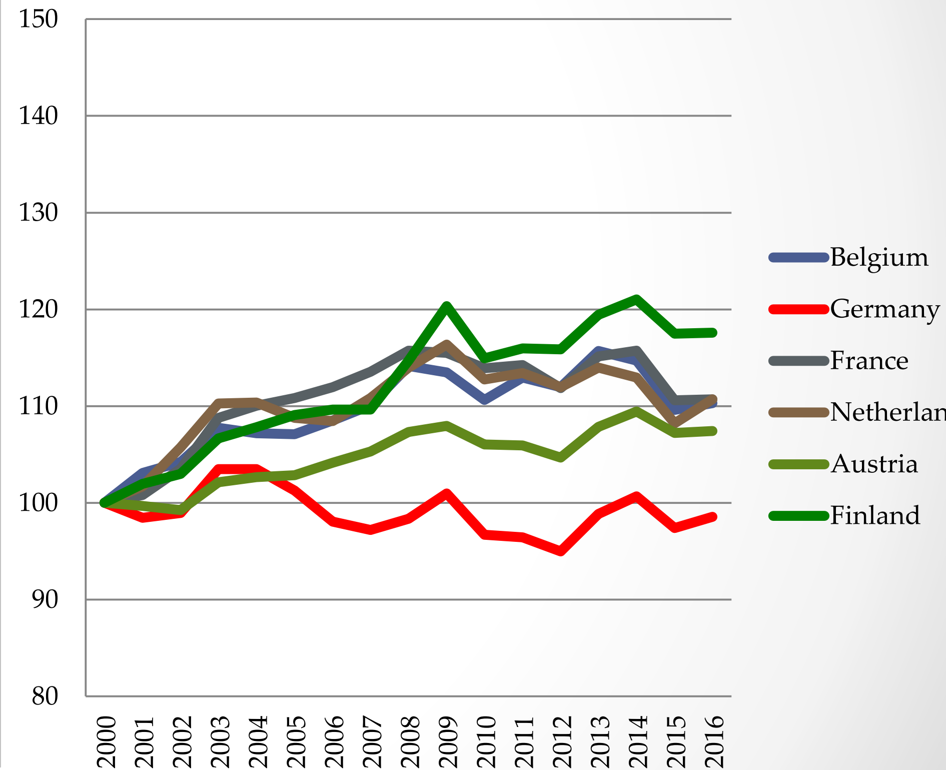
- These were strongly synchronized in Eurozone
- Asymmetry was in the amplitude of the booms and busts
    - Some countries (Ireland, Greece, Spain) experiencing wild swings
    - While others (Germany, France, Netherlands, Belgium) experiencing mild swings


Business cycle component of GDP
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
NetherL
Portugal
Spain

- This led to two problems
  - Build-up of large divergences in competitive positions
  - Instability in government bond markets during downswing

Diverging trends in competitiveness





- Adjustment through internal devaluation very painful
- Asymmetry in adjustment puts all the costs of the adjustment onto the deficit countries
- All this leads to political upheaval
- And dynamics of rejection

Second problem:
No stabilizers left in place

- Absence of lender of last resort in government bond market in Eurozone
- exposed fragility of government bond market in a monetary union
- Self-fulfilling crises pushing countries into bad equilibria

Fragility of government bond market in monetary union

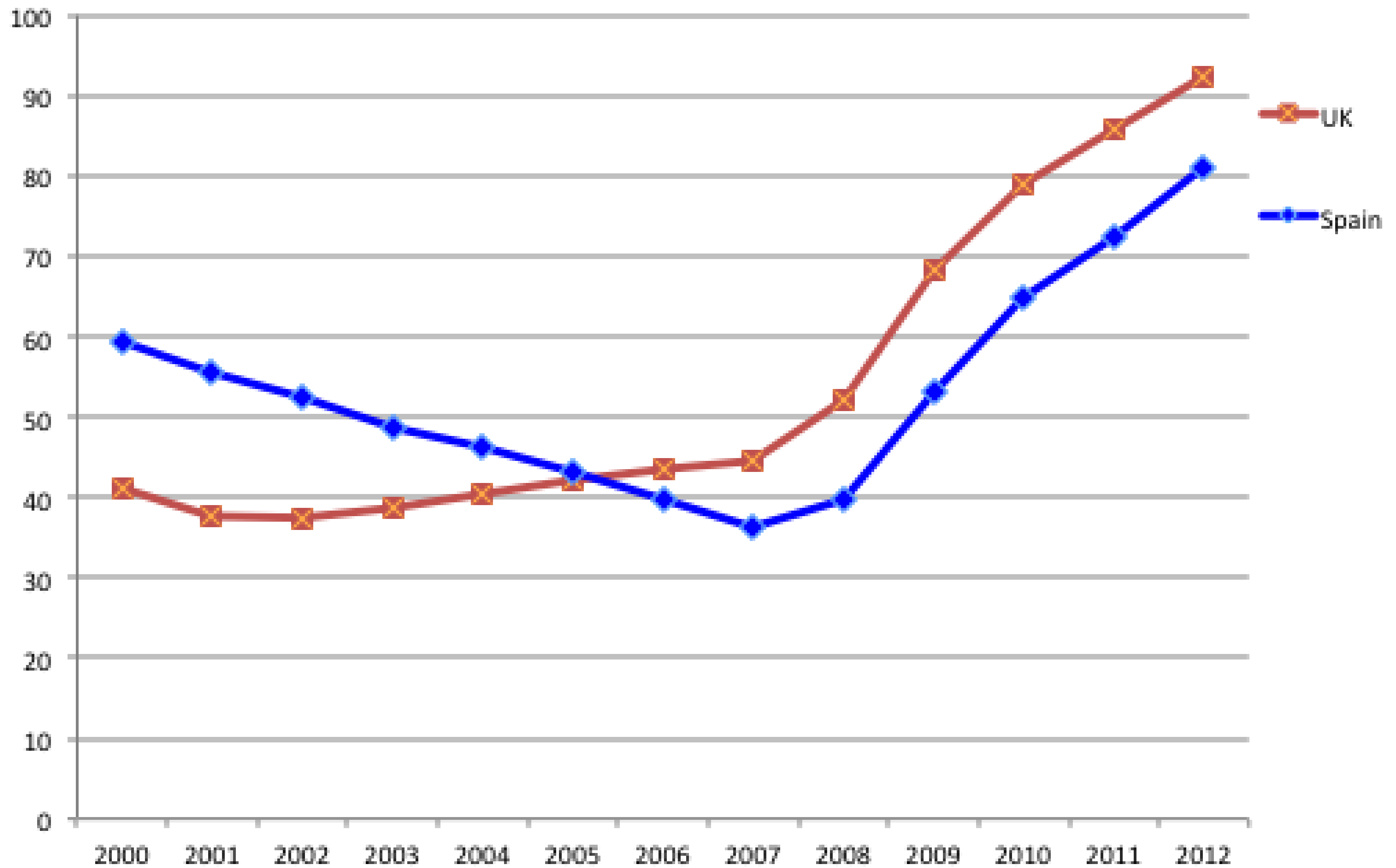
- Governments of member states cannot guarantee to bond holders that cash would always be there to pay them out at maturity
- Contrast with stand-alone countries that give this implicit guarantee
  - because they can and will force central bank to provide liquidity
  - There is no limit to money creating capacity

Self-fulfilling crises

- This lack of guarantee can trigger liquidity crises
  - During recession, budget deficits increase automatically
  - Distrust leads to bond sales
  - Interest rate increases
  - Liquidity is withdrawn from national markets
  - Government unable to rollover debt
  - Is forced to introduce immediate and intense austerity
  - Intensifying recession and Debt/GDP ratio increases

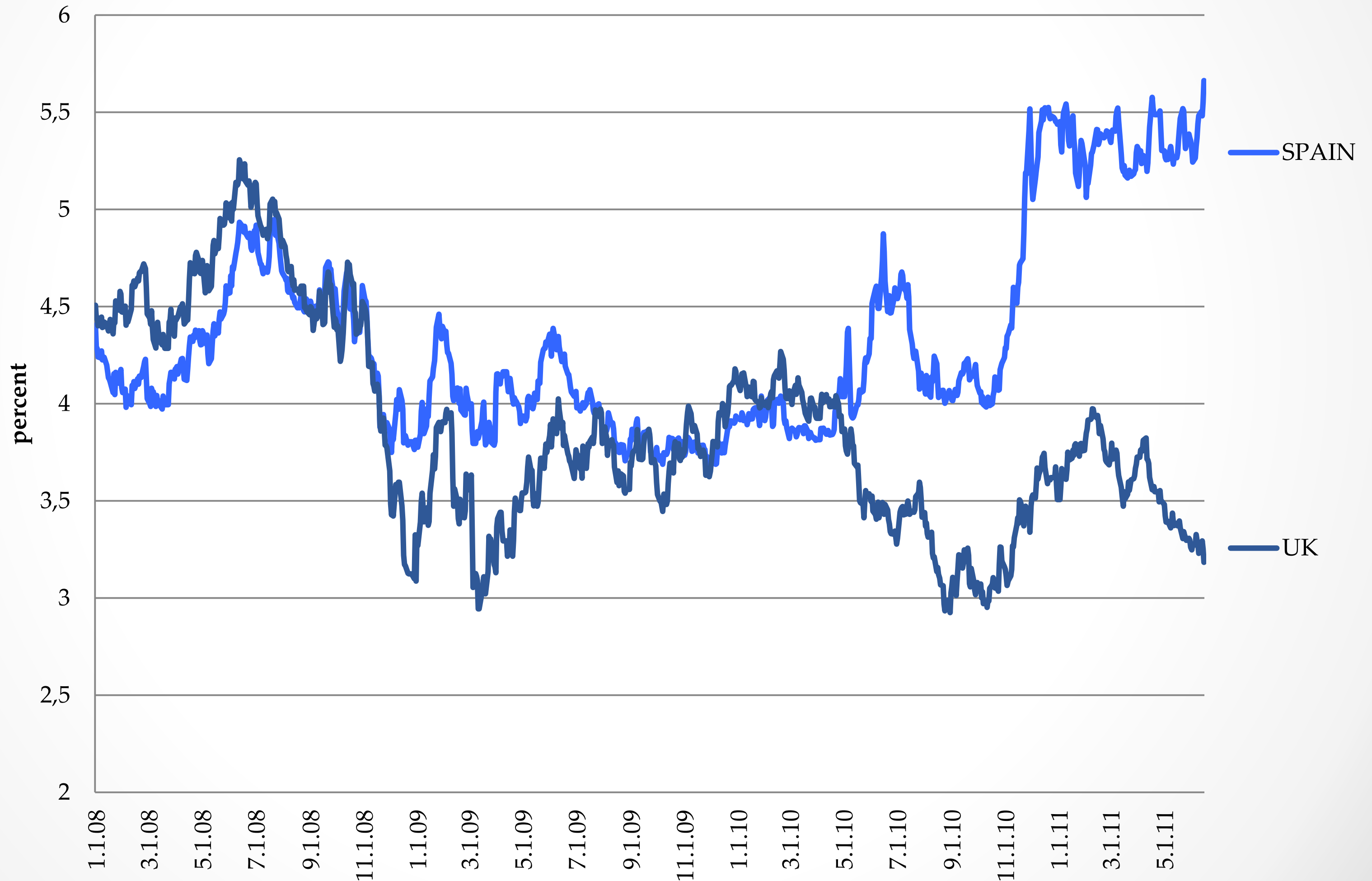
- This leads to default crisis
- Countries are pushed into bad equilibrium
- That can lead them into default

- Thus absence of LoLR tends to eliminate other stabilizer: automatic budget stabilizer
    - Once in bad equilibrium countries are forced to introduce sharp austerity
    - pushing them in recession and aggravating the solvency problem
    - Budget stabilizer is forcefully switched off
- Investors know this and flee from the government bond markets hit most by recession to invest in bond markets less hit by recession
- Destabilizing capital flows in monetary unions
- Case study: pain in Spain



Gross government debt UK and Spain (% of GDP)
100
90
80
70
60
50
40
30
20
10
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
UK
Spain

10-Year-Government Bond Yields UK-Spain



Redesigning the Eurozone

How to redesign the Eurozone?

- Role of ECB
- Budgetary and Political Union

The common central bank as lender of last resort

- Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because central bank will provide all the necessary liquidity to sovereign.
- This outcome can also be achieved in a monetary union if the common central bank is willing to buy the different sovereigns' debt in times of crisis.

ECB has acted in 2012

- On September 6, ECB announced it will buy unlimited amounts of government bonds.
- Program is called "Outright Monetary Transactions" (OMT)
- Success was spectacular

Success OMT-program

30,00
25,00
20,00
15,00
10,00
5,00
0,00

Greece
Portugal
Ireland
Italy
Spain
Belgium
France
Austria
Finland
Netherlands

2008M01
2008M05
2008M09
2009M01
2009M05
2009M09
2010M01
2010M05
2010M09
2011M01
2011M05
2011M09
2012M01
2012M05
2012M09
2013M01
2013M05
2013M09
2014M01
2014M05
2014M09
2015M01
2015M05
2015M09
2016M01
2016M05
2016M09
2017M01

- This was the right step: the ECB saved the Eurozone
- However, the second Greek crisis of 2014-15 casts doubts about the willingness to activate OMT in future
- And surely there will be new crises when next recession hits
- We need more than lender of last resort

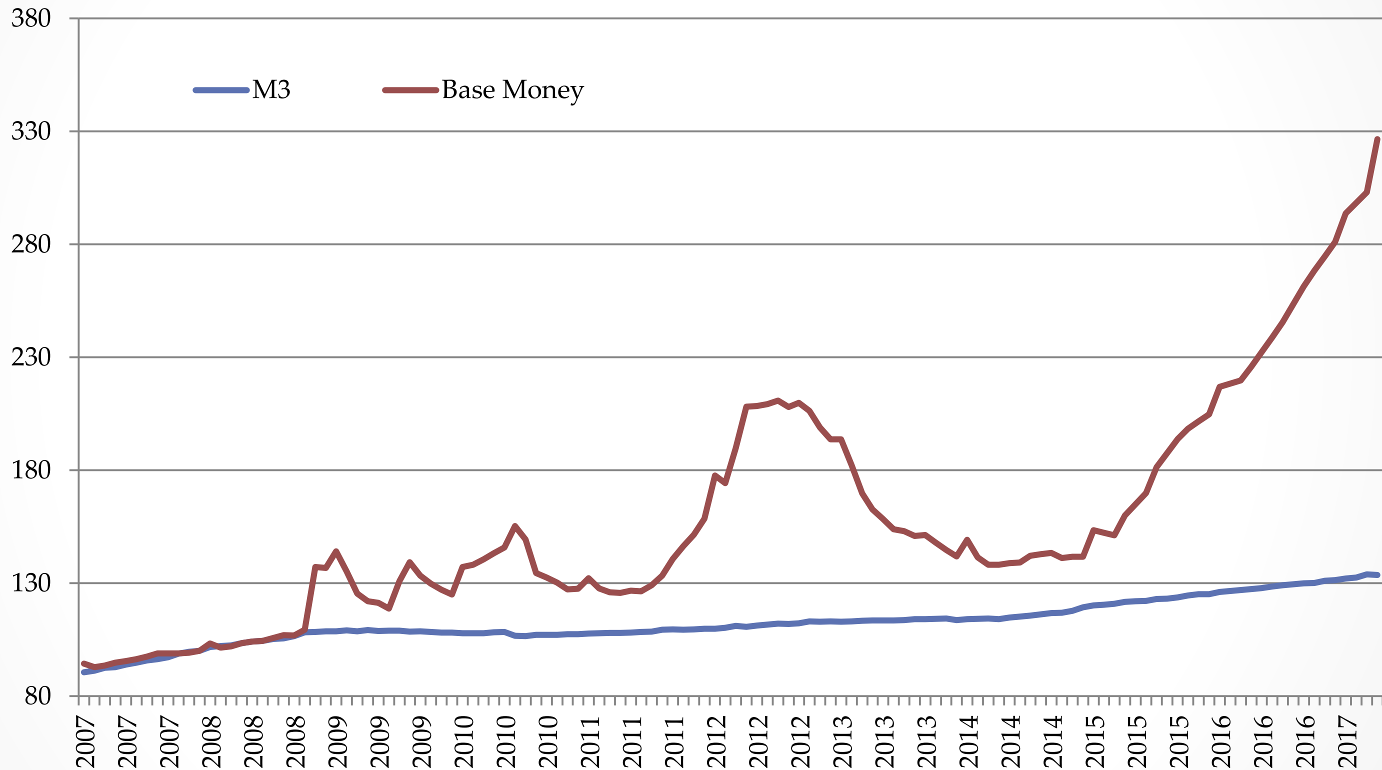
Criticism of OMT

- Points of criticism
  - Inflation risk
  - Moral hazard
  - (Fiscal implications)
- Is this criticism valid?

Inflation risk

- Distinction should be made between money base and money stock
- When central bank provides liquidity as a lender of last resort money base and money stock move in different direction
- In general when debt crisis erupts, investors want to be liquid

Money base and money stock (M3) in the Eurozone 2007



- Source: European Central Bank

- Thus during debt crisis banks accumulate liquidity provided by central bank
- This liquidity is hoarded, i.e. not used to extend credit
- As a result, money stock does not increase much;
- No risk of inflation

Moral hazard

- Like with all insurance mechanisms there is a risk of moral hazard.
- By providing a lender of last resort insurance the ECB gives an incentive to governments to issue too much debt.
- This is indeed a serious risk.
- But this risk of moral hazard is no different from the risk of moral hazard in the banking system.
- It would be a mistake if the central bank were to abandon its role of lender of last resort in the banking sector because there is a risk of moral hazard.
- In the same way it is wrong for the ECB to abandon its role of lender of last resort in the government bond market because there is a risk of moral hazard

Separation of liquidity provision from supervision

- The way to deal with moral hazard is to impose rules that will constrain governments in issuing debt,
- very much like moral hazard in the banking sector is tackled by imposing limits on risk taking by banks.
- In general, it is better to separate liquidity provision from moral hazard concerns.
- Liquidity provision should be performed by a central bank; the governance of moral hazard by another institution, the supervisor.

- This should also be the design of the governance within the Eurozone.
- The ECB assumes the responsibility of lender of last resort in the sovereign bond markets.
- A different and independent authority (European Commission) takes over the responsibility of regulating and supervising the creation of debt by national governments.
- This leads to the need for mutual control on debt positions, i.e. some form of political union

Metaphor of burning house

- To use a metaphor: When a house is burning the fire department is responsible for extinguishing the fire.
- Another department (police and justice) is responsible for investigating wrongdoing and applying punishment if necessary.
- Both functions should be kept separate.
- A fire department that is responsible both for fire extinguishing and punishment is unlikely to be a good fire department.
- The same is true for the ECB. If the latter tries to solve a moral hazard problem, it will fail in its duty to be a lender of last resort.

Towards a budgetary and political union

- Most important component of political union is budgetary union.
- What do we mean with budgetary union?

Budgetary union has two dimensions

1. consolidation of national government debts.
   - A common fiscal authority that issues debt in a currency under the control of that authority.
   - This prevents destabilizing capital movements within the Eurozone
   - and protects the member states from being forced into default by financial markets.

2. Insurance mechanism

- mechanism transferring resources to the country hit by a negative economic shock.
- Limits to such an insurance: **moral hazard** risk,
- But that is problem of all insurance mechanisms
- Budgetary union also allows to stabilize the business cycle at the Eurozone level

Strategy of small steps

- Budgetary union (consolidation of national debts and insurance mechanisms) is necessary in long run
- Budgetary union as defined here can only be a very long-run process
- There is no political willingness today to realize this quickly
- Only strategy of small steps can have some probability of success

Common unemployment benefits scheme as a small step

- Many proposals have been made: e.g. Four Presidents report
- Common unemployment schemes should be allowed to have deficit during recession compensated by surpluses during boom
- This means issuing common bonds
- First step on the road to budgetary union

Conclusion

- Long run success of the Eurozone depends on continuing process of political unification.
- Political unification is needed because Eurozone has dramatically weakened
  - the power and legitimacy of nation states
  - without creating a nation at the European level.
- This is particularly true in the field of stabilization

Conclusion: Integration fatigue

- Budgetary union is needed but is far away
- Willingness today to move in the direction of a budgetary and political union in Europe is very weak.
- This will continue to make the Eurozone a fragile institution
- Its long-term success cannot be guaranteed

Brexit

Introduction

- Political objective of Brexit is to "take back control over borders, laws and money",
  - i.e. it is an objective of full sovereignty.
- The PM claims that this is possible while going global,
  - i.e. while at the same time pursuing free trade agreements that will keep the UK fully anchored into the global economy
- and all this while maintaining democratic decision making processes.

Impossible trilemma

- These objectives of full sovereignty, democracy and globalisation are inconsistent.
- This follows from Rodrik's "impossible trilemma" theorem
- This says that only two of the three objectives can be satisfied simultaneously
  - If UK chooses for sovereignty and democracy it cannot have globalisation, i.e. it will have to move towards protectionism.
    The reason is that globalisation imposes rules on nations that reduce its sovereignty.
  - Whether these rules come from Brussels or from elsewhere is of no importance

Fantasy world

- These inconsistent objectives pursued by the UK government have created a fantasy world in which this government continues to operate
- The awakening will be rude forcing the government to make hard choices.
- Two scenarios:
  1. UK obsessed with sovereignty
  2. UK wants to keep borders open

Scenario 1

- Primacy of national sovereignty
- This implies a refusal to accept rules imposed from outside the UK and the jurisdiction of ECJ on British soil
- UK will end up in a situation where it has to take on the WTO statutes that will lead to the imposition of import tariffs and full control over immigration
- This is the only option that preserves the objective of sovereignty and democracy.

Implications for trade

- “New globalisation” is very different from “old globalisation” (Richard Baldwin)
- Old globalisation was based on strong reduction of the cost of moving goods, while the cost of moving ideas and people did not decline at the same rate.
- The ICT revolution has changed this
- It has made it possible to substantially reduce the cost of moving ideas.

- As a result, it became possible to “unbundle” production stages
- and transfer many of these to other countries
- This has created long “global value chains” that encompass many borders
- leading goods to frequently cross the same borders
- while with each border crossing new components have been added
- Result: A BMW is not a German car and Iphone is not an American product

- A country that introduces protectionism (US, UK) cuts itself off from this global production networks
- and will see its competitiveness decline significantly
- Thus the UK, when leaving the single market, will cut itself off from the production network with Europe which is the most significant one.
- The UK government has created the myth that while it cuts itself from the European network and value chains
- It will easily replace this with new global networks.
- This is Wonderland Economics

Scenario 2

- In this scenario UK keeps primacy of open borders
- This can only happen if it accepts rules originating and monitored outside Britain
  - The Norwegian model
  - The Swiss model
- The latter is most likely
- Even there Britain will loose in that it is not part of decision making process.

Implications for the EU

- Good news
- Brexit creates window of opportunities to strengthen the union
- Why?
- Historically strategy of UK has always been to ensure that Europe remains weak
- After World War 2 it first refused to join because it speculated that European integration effort would lead nowhere

- When it became success, it asked to join
- Not to strengthen the union
- But to make sure it would no become strong
- Or worse to deconstruct it from inside
- It tried as much as possible to impose inter-governmental system where each country maintains veto power
- If that did not work it negotiated opt-outs

- UK was a member country dedicated to keeping the union weak.
- Now that it is leaving, a window of opportunity is created to go forward
    - In defence
    - In taxation