ECONOMIC IMBALANCES AND INSTITUTIONAL CHANGES TO THE EURO AND THE EUROPEAN UNION

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ECONOMIC IMBALANCES AND INSTITUTIONAL CHANGES TO THE EURO AND THE EUROPEAN UNION

INTRODUCTION

Increasing external and internal imbalances that emerged early since the establishment of the Euro Area revealed flaws in the economic and institutional architecture of the single market. Recent economic and debt crisis highlighted the serious lack of confidence in the ability of the Euro Area to face challenges resulting from political and economic development in the Euro Area countries as well as the world economy. It has stressed the crucial need to find a systematic and consistent solution to the current problems of the Euro Area.

Limited maneuverability of the ECB's monetary policy induced by the low interest rate environment highlighted increasing role of fiscal policy in reducing negative effects of external and internal shocks on macroeconomic performance of the Euro Area member countries. However, many empirical studies emphasize the existence of asynchronous features strongly embedded in the mix represented by national fiscal policies combined with singly monetary policy that increases heterogeneity among the Euro Area member countries and thus reduces the overall benefits of deeper economic integration. As a result, there is an urgent call for stronger fiscal integration and establishment of the fiscal union within the Euro Area that could bring large number of benefits reducing asymmetric internal and external imbalances in the member countries and, as a result, increase the overall competitiveness of the Euro Area. However, deeper fiscal unification of countries with heterogeneous macroeconomic environment would induce higher occurrence of undesired exogenous shocks. As a result, it seems to be reasonable to consider alternative approaches of the route to fiscal union that are intensively discussed by both economists and politicians. Key pillars of the fiscal union design as well as particular steps toward its establishment faces the problem generally known as trust to institutions due to economic and debt crisis implications. Decreasing confidence and trust to

institutions revealed fragility of the institutional framework of the Euro Area that is why the recent crisis put on the agenda to redesign the Euro Area due to the lack of symmetry between "economic" and "monetary" union.

However, reduction of excessive economic imbalances that would improve performance and competitiveness of the Euro Area as a whole in the recent post-crisis period requires comprehensive examination of the causes and origins of the recent problems in the European Monetary Union. As many economists (i.e., Paul De Grauwe) suggest, the Euro Area as a very ambitious step forward deeper integration among European economies suffers from the design failures that reduces generally expected outcomes of the single currency. This book provides rigorous insights into the problems inevitably associated with design failures in the Euro Area that contributed to the rise and deepening of the external and internal imbalances within the monetary union.

Incorrect Diagnostics of the Public Finance Crisis refers to the notion that irresponsible national fiscal policies represent a primary reason of a debt crisis occurrence in the European countries. However, the main reason of the debt crisis is rather unsustainable accumulation of a private debt. General government, as the only sector in economy, did not increase its indebtedness during the pre-crisis period. Unsustainable private debt accumulation and linked processes led to the effect of so-called debt deflation. The only way out from deflation spiral accompanied by the recession is the rise of public debt burden that should help countries to avoid serious recession.

Single Monetary Policy Failure is associated with idea that the *loss of monetary autonomy* and associated loss of the lender of last resort may induce a self-fulfilling liquidity crisis. This consequently caused solvency problems. Credibility loss in peripheral countries resulted in sale of government bonds and sharp increase in interest rates and capital spill over to "safe" countries. Increasing *gap between investments and savings* in peripheral countries was implied mainly by decreasing volume of savings before crisis. The trend was even more amplified by lower real interest rate in the south (because of lower inflation) than in the north of the Euro Area. This fact reflected the loss of market capacity to perceive specific country risk (nominal interest rate convergence). Therefore, quantitative easing can be considered as an ECB failure. In the countries with lack of savings, interest rate increase would stimulate their creation in private (private debt reduction) and public sector (fiscal deficit reduction). *Centralized approach to monetary policy* in the Eurozone together with nationally oriented macroeconomic policies is considered as important source of idiosyncratic effects. Endogenous dynamics of convergence, which was efficient at the national level, has almost entirely disappeared at the level of the Euro Area.

Heterogeneous Macroeconomic Environment refers to the notion that performance-related increase in the gap between investments and savings directed to formation of two blocks of countries in the Euro Area – debtors and creditors in the south, and north of Europe, respectively. Low interest rates environment

during the pre-crisis period and quantitative easing during crisis make these problems persistent. Asynchronous evolution of competitiveness in the Euro Area during pre-crisis period even contributed to this problem. Southern countries experienced significant increase in relative unit labor cost (ULC), while ULC stagnated in northern countries and fell down in Germany. However, ULC sharply decreased in peripheral countries during the crisis. Internal devaluation had highly negative impact on output and employment in debtor countries.

Asymmetry in Macroeconomic Policies refers to the notion that solutions based on reduction of expenditures in the debtor countries without expansionary policy conduction in the creditor countries led to aggravation of recession and escalation of debt crisis. Nevertheless, debtor and creditor countries should spend less or more, respectively (redistribution of expenditures). However, this requires high degree of national fiscal policy coordination. Above-mentioned problems with liquidity resulted in abandoning automatic fiscal stabilizers and the countries had to implement fiscal consolidation.

Obstacles for Policy Coordination refers to the notion that crisis period revealed flaws and fragile patterns in the institutional architecture of the European Union. Insufficient guarantees to preserve fiscal responsibility (Stability and Growth Pack, Fiscal Compact), controversial low interest rate single monetary policy, asymmetric and massive fiscal consolidation, and the lack of coordination in both economic policy and institutional levels are just few examples of flaws in the European Union institutional framework that clearly reduces the policy driven recovery of the European Union from the crisis.

This book offers a critical perspective from which to observe evolution of the Euro Area and the European Union in these times of growing economic and political conflict. Key implications of above-mentioned design failures in the Euro Area and their contribution to the excessive external and internal economic imbalances will be critically discussed from the economic, policy, and institutional perspectives. This critical insight is used to examine both institutional asset and economic performance of Europe after the crisis, moving from the authors' shared perspective that the crisis revealed the weak aspects of the whole architecture of the European Union. The birth of a new currency union in 1999 represented such an important historical political and institutional event that it was expected to reshape the international relations in the globalized context. The first steps of Currency Union came after the collapse of the Exchange Rate Mechanism (ERM) in 1992. It marked the end of success of cooperative economic policy, revealed the conflict between internal and external policy objectives, and showed the existence of asymmetries among countries adhering to the exchange rate agreements. The solutions proposed to overcome these flaws brought to build the Single Currency Area: they pointed to radically remove the constraints and move on a shared level the alleged policy mechanisms source of divergences. As a matter of fact, the European Monetary Union

was built on two policy principles: (a) a single monetary policy and (b) a fiscal policy based on a strict budgetary discipline left to the management of individual states. This was supposed to contain interest rate differential, stabilize inflation, and assure the convergence process toward a uniform rate of growth. However, despite in the first years, it appeared to have created a trusted environment assuring capital to perfectly move from one country to another, after 2007, differences in inflation rates, in interest rates, in productivity, in fiscal policy performance and external competitiveness became abruptly evident. The existence of a single monetary policy and fiscal policy left to the management of individual states gave rise to asymmetrical effects on growth and self-fulfilling processes of divergences.

The divergences transmitted to European citizens the belief that the European bodies were unable to manage the difficulties and an ever decreasing trust in institutions, both political and economic ones, has been registering in the continent (see Eurobarometer). The greater fragility of some countries in respect to others has triggered a backward process in which national interests have started to prevail over those of both the currency area and the entire European Union. In turn, this fueled a progressive decline in confidence in the European institutions and is creating growing questions of interpretation both in terms of economic theory and institutional asset. The hot coals of the fragility of the banking sector, the unsustainability of public accounts, and the external imbalances seem to be, after almost 10 years from the eruption of the crisis and after 25 years from the ERM collapse, suffocated with difficulty under the ashes rather than permanently extinguished. The causes of the collapse of the ERM were reproduced, but with limited policy instrument to fight them. This time however it is much more difficult, complex, and implying political consequences to go back.

This book, containing contributions from international scholars both expert and young, focuses on these issues and provides an analytical investigation on the process of the European institutional and economic integration. It offers an analysis of the main causes of the institutional and economic decline of the European Union and provides some proposals to face the challenges for the future.

It is divided into three sections. Each of them analyses the institutional architecture, the policy model and the economic outcomes of the Euro Area from different perspectives with the aim of revealing the economic and institutional imbalances of both the currency area and the European Union as a whole. They are as follows:

(1) Institutional and political issues in the policy framework of the Euro Area.
(2) Monetary policy, the banking system, and financial integration.
(3) Macroeconomic imbalances and the convergence process.

The first section contains chapters investigating on the general institutional and policy framework of the Euro Area. Mariangela Bonasia and Rosaria

Rita Canale in the chapter *The Euro Area Policy Model and the Institutional Consolidation Process in the Long-run* discuss the theoretical limits of the European policy model on the basis of an inverse relationship both in the short and in the long run between trust in institutions and unemployment. This empirical outcome suggests that the European process of integration and institutional consolidation goes through a greater attention devoted to the rate of unemployment. Elina De Simone Marcella D'Uva and Giuseppe Gaeta ask the reader the question "Loving Europe or Not?" and provide an "Empirical Analysis of the Determinants of National Political Parties' Orientation towards the European Union." Adopting a national perspective they intersect the economic outcomes with national parties' political orientation in supporting the European integration process. With the support of their empirical results, it is possible to make an extension and deduce that poor economic outcomes are supposed to increase the consent toward ideologically extreme parties that are, on average, less supportive of European integration. The next three chapters focus on policy institution specifically: *Development-Related Problems in the Euro Area: The Challenge of the 'Strategic' Approach* by Nikolaos Karagiannis and Edward K. Zajicek deepens the regional and industrial problems in the context of the European Union and Euro Area and discusses the connected policies. A comparison with United States and Japan is also implemented in order to offer alternative policy recommendations based on the developmental state line of argument. *Rules, Imbalances and Growth in the Euro Area* by Daniele Schilirò highlights rules and institutions that have characterized the European Monetary Union during this prolonged crisis and discusses the policies implemented in the Euro Area, stressing the limits of the strategy pursued by the European authorities. The main purpose of the chapter is to indicate some economic solutions and political arrangements in order to complete the institutional system of the EMU. This requires appropriate reforms of its institutional architecture, where a key point is fiscal union. But such reforms require changes in the treaties so to the Eurosystem more consistent and endowed of democratic legitimacy, so to have the tools, resources, and policies necessary to contribute to the development, stability and cohesion of the Euro Area countries. Finally, the chapter *Back to National Currencies? Monetary Integration in an Asymmetrical Currency Area* by Sergio Rossi argues that monetary integration must precede, rather than follow, monetary unification, in order to avoid the occurrence of structural and systemic crises. It points out that adopting the euro as single currency for a number of heterogeneous countries led inevitably to a number of major negative effects, so much so because of the counterproductive financial constraints induced by the euro-area fiscal and monetary policy framework. It suggests to introduce a monetary-structural reform that will be instrumental in increasing financial stability and employment levels across Europe, thereby inducing positive effects also for trade and public finance. They all three underline, even if from different perspectives, the flaws of the institutional architecture of the Euro Area and offer some suggestions to overcome them.

The second section deals with the monetary policy, the banking system, and financial integration. The first two chapters concentrate on the conduct of the monetary policy. The contribution by Joerg Bibow *From Anti-growth bias to Quantitative Easing: The ECB's Belated Conversion?* identifies an anti-growth bias in the ECB's monetary policy approach: the ECB is quick to hike, but slow to ease. It needs a "Euro Treasury" partner to overcome the euro regime's most serious flaw: the divorce between central bank and treasury institutions. On less critical positions stands the chapter *Quantitative Easing (QE) in the Euro Area* by Marta Orviská and John Hudson. The main thesis is that the use of QE helped governments to deal with the immediate aftermath of the crisis and possibly prevented much sharper recessions than we witnessed. But in many ways its impact on the real economy has been limited and there are dangers in both the potential for substantial inflation to occur at some point in the future and the weakening of the financial sector.

The following three chapters investigate on the banking system and financial sector as indicators of the Monetary Union performance. Pasquale Foresti and Oreste Napolitano in their chapter *Updating the Evidence on Risk-Sharing through the Cross-Ownership of Financial Assets in the Euro-Area* argue that risk-sharing is a crucial issue in order to evaluate the performance of a monetary union. They estimate the degree of risk-sharing through the cross-ownership of assets within 11 European countries in the period 1971–2014. The results seem to represent the evidence of a missing element of the EMU that forced governments to intervene by means of fiscal policy to tackle the imbalances deriving from the financial crisis. The weakness in the risk-sharing has been one of the channels that allowed the global financial crisis to mutate in a sovereign debt crisis in the EMU. Further deepening on financial integration is provided by the Jan Babecký, Luboš Komárek, and Zlatuše Komárková's empirical contribution *Financial Integration at Times of Crisis and Recovery*. The analysis covers a wide range of markets and countries and reveals deviations from the arbitrage conditions during the crisis that after 2015 appear to be almost – if excluding the government bond markets – to pre-2007 levels. A wide reflection on the banking system and financial integration concludes this section. Dragan Momirović, Marko Janković, and Maja Ranđelović in their *EU Banking Union-Expectations Risks and Challenges* examines the issues of the Banking Union (BU) and the complex architecture of banking system surveillance. It is expected to preserve the single market and the common currency, breaking "toxic connections" between sovereign debt and banks, mitigation and removal of financial instability and economic growth. However, it seems the political will of national governments to give up sovereignty over its banking sector and transfer onto competencies to the supranational institutions to be a key factor in the success or failure of BU.

Finally, the issue of imbalances and convergence is addressed in the third section. According to Collin Constantine, differences in "Competitiveness and Macroeconomic Imbalances in Euro Area Countries" are not a failure of

nation states. The convergence criteria – limits on government deficit, debt, interest rate, and inflation – completely ignored differences regarding technological frontiers, the main determinant of the key macroeconomic imbalances across the Euro Area. The nominal price competitiveness criterion appears to be inadequate to assure convergence since there are deep differences in the productive structure. The imbalances issue is examined from the perspective of the differences in current accounts by Rajmund Mirdala and Júlia Ďurčová in their contribution *Current Accounts and Competitiveness Issues in the Euro Area*. Asynchronous current account trends between North and South were registered in the Euro Area and the author investigates on the underlying causes. The issue is whether they are due to differences in real exchange rate or in domestic demand. The empirical results indicate that while prices' and costs' related determinants of external competitiveness affected current account adjustments during the pre-crisis period, demand drivers shaped current account balances during the crisis period. The next chapters deal with fiscal imbalances in relation the country-specific cyclical position and monetary policy asymmetries. Ines Kersan-Skabic wonders whether "there is a debt-overhang problem in the European Union." Through the empirical analysis, she finds out a bi-directional impact of public debt on GDP growth rate, unemployment, current account, and interest rate spread. Tiago Cardao-Pito in his *Are they all the same? Banking and financial crises in debt-ridden Euroarea countries* states that the intra euro-area imbalances were already present before the financial crisis and that followed distinct evolution paths. Therefore, uniform prescriptions for each country encompassing all post-euro crises cannot exist, but rather may cause self-fulfilling processes of divergences. A special attention in creating fiscal imbalances is devoted to capital flows in the chapter *The Recent Experiences of Capital Flows and Fiscal Imbalances since the Creation of the Euro Area* by Yaya Sissoko and Brian W. Sloboda.

The creation of the Euro Area provided some fiscal and monetary stability up until the shock of the 2008 Financial Crisis. After that the interaction between current account and fiscal imbalances started to spread throughout the Euro Area members and many of them began to engage in policies in the attempt to restore stability and to stem capital outflows by implementing fiscal reforms. The author concludes that the Euro Area member countries need to re-examine best practices to implement fiscal policies that are resistant to intense financial shocks. The role of monetary policy in fiscal imbalances is examined in the chapter *Intra-European Union Imbalances and Cyclical Position: Does Monetary Policy Matter?* by Jean-Pierre Allegret and Aufrey Sallenave. The investigation is made upon some Baltics and South-Eastern European countries as well as peripheral European countries over the period 2000–2013. The general conclusions are that monetary policy was ineffective to face imbalances, the fiscal policy prescriptions generated pro-cyclical results, coordinated macro measures, and surveillance tools are needed. Convergence processes in the sectorial international competitiveness of the Eurozone area

countries are analyzed in the chapter by Roberto J. Santillán-Salgado and Araceli Ortega-Díaz. Authors deal with dilemma whether unexpected Euro Area sovereign debt crisis originates in a "contagion" effect of the subprime mortgages financial crisis in the United States or whether it is just a generally expected implication of deeper fundamental economic imbalances among Euro Area member countries. As the adoption of the euro created highly favorable conditions for increasing convergence, authors suggest that in 4 of 10 export sectors a significant evidence of international competitiveness convergence can be found while there is no significant evidence of divergence in the rest sectors. The last chapter addresses the Euro area countries debt-problem, not only from an economic perspective, but also from a political point of view. Julius Horvath and Alfredo Hernandez in their *Sovereign Debt Crisis: Euro-Reality* explore the different sources of sovereign debt crises: on one side the opportunistic and myopic behavior by debtor nations, and on the other side credit temptation by lenders, eager to allocate savings surpluses.

It emerges from the contributions that the European convergence process is extremely problematic. The issues of the compliance to rules appear to question the economic and political project for Europe as a whole and national perspectives prevail on supranational ones.

There are two scenarios which may occur: the first one, in which European institutions insist on the "efficient" working of the present policy framework. Following this point of view, single states are asked to make adjustments on their own. In particular, the peripheral countries have to bear the whole cost of rebalancing the currency area, while the core ones – in spite of having profited from the weakness of the Euro – remain at best as passive onlookers. However sooner or later, they will suffer from the negative spill-over effects.

The alternative scenario is to remove some constraints and start thinking to Europe as a single body. The Euro Area asymmetries cannot be realigned without shared policy action. It is clear that Europe is built upon a strong contradiction the crisis has explicitly revealed: the absence of common institutions in the presence of a common market. In imagining the future, single countries should have in mind that, in a globalized context, it is extreme difficult to pursue internal policy objectives and be aware that in order to move a step ahead, a quantum leap toward a political union would be required.

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