The Economics of the Monetary Union and the Eurozone Crisis

Este libro, The Economics of the Monetary Union and the Eurozone Crisis, publicado por Springer, destaca ideas, recomendaciones y conclusiones resultantes de muchos años de análisis e investigación en la Comisión Europea, donde el autor trabajó como empleado público desde 1986, encontrándose actualmente en excedencia voluntaria. El libro tiene un prólogo del Profesor Paul De Grauwe, de la London School of Economics, y recoge en 6 capítulos las 6 Clases Magistrales que el autor fue invitado a impartir en octubre de 2012 en el Master European Studies of Maastrich University. El libro subraya que el proyecto del euro es de naturaleza estrictamente política, mientras que su racionalidad económica es todavía torpe, y que ambos ámbitos están hoy en conflicto directo. Los europeos tienen hoy en día un único tipo de política monetaria para todo la Euro Área, lo que obliga al Banco Central Europeo (BCE) a mirar con más atención a las necesidades económicas de los países centrales que a la de los socios periféricos.

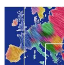
That the euro was in trouble became evident after the financial markets' turmoil the summer of 2007. Credit markets became risk-averse and peripheral countries showed high fiscal deficits and strong debt/GDP ratio dynamics. This feature caught the eye of international investors and brought about a *sudden stop* in the external financing for the peripherals. The current crisis demonstrates that regions of a currency area cannot adjust when facing shocks because of diverging trends in both labour costs and productivity, and in the saving/investment balance. Any shock absorption would require well functioning markets, free movement of factors of production and flexible wage formation processes within the area.

> "Under the leadership of the European Commission and the ECB tight austerity was imposed on the debtor countries while the creditor countries continued to follow policies aimed at balancing the budget. This has led to an asymmetric adjustment process where most of the adjustment has been done by the debtor nations. The latter countries have been forced to reduce wages and prices relative to the creditor countries (an "internal devaluation") without compensating wage and price increases in the creditor countries ("internal revaluations").
> These internal devaluations have come at a great cost in terms of lost output and employment in the debtor countries. As these internal devaluations are not yet completed (except possibly in Ireland), more losses in output and employment are to be expected.
> Thus, the burden of the adjustments to the imbalances in the eurozone between the surplus and the deficit countries is borne almost exclusively by the deficit countries in the periphery. This creates a deflationary bias that explains why five years after the start of the financial crisis the Eurozone still has not recovered and threatens to return into a recession.
> The risk is real that citizens in Southern European countries that are subjected to prolonged deep economic downturns revolt and reject a system that was promised to them to be economic heaven.
> In order to understand these dramatic economic developments that grip the Eurozone the book of Manuel Sanchis i Marco is the right one coming at the right time. The theory of optimal currency areas remains the essential framework to understand the design failures of the Eurozone. Professor Sanchis i Marco does a superb job in explaining this theory and in making it relevant for our understanding of the problems faced by the Eurozone" [Prof. Paul De Grauwe, London School of Economics]

The book highlights important policy recommendations to be drawn because, with no adjustments in nominal exchange rates, external disequilibria in the Eurozone can only be achieved through changes in relative prices and costs; therefore, several alternative scenarios emerge. First, capital transfers via the EU budget, something politically unacceptable to Germany. These transfers should not aim at subsidizing incomes but rather to help equalize production conditions through public investment. Second, internal devaluations of the peripherals, and internal revaluations in core countries through an expansion in labour costs. Third, accommodating monetary and euro depreciation policies by the ECB. And, finally, a combination of the previous three.

> "The ECB decided in September 2012 to act as a lender of last resort in the government bond markets of the Eurozone. In doing so it prevented panic from undermining the stability of the Eurozone. It was a necessary move to eliminate the existential fear that was destroying the Eurozone.
> While necessary, the ECB decision is insufficient to save the euro in the longer run. The greatest threat for the Eurozone today does not come from financial instability but from the potential social and political instability resulting from the economic depression in which Southern European countries have been pushed into and that has led to increases in unemployment not seen since the Great Depression. This state of affairs is the result of a dramatic failure of macroeconomic management in the Eurozone.
> The last two chapters of the book turn towards an analysis of the crisis of the euro and how to get out of this crisis. Spain is used as the prototype country to explain how the crisis unfolded. This is the country that in the beginning of the Eurozone seemed to do everything right. Few saw how the imbalances were building up; even fewer predicted that this would lead to disaster. This book produces the best analysis I have seen of why things have gone wrong so badly in Spain. By suggesting a path out of the crisis, Professor Sanchis i Marco leaves us with some hope for the future for Spain and other Eurozone countries." [Prof. Paul De Grauwe, London School of Economics]

The Heads of State and the Heads of Government betray the construction of Europe by emptying it of all content when they favour the diktat of the bureaucratic elites against the political legitimacy of the EU as a supranational democratic community shored up by a legal framework. The strategic and political course that Germany has set weakens its commitment to the construction of Europe, undermines the credibility of German political support of the current political initiatives to complete the Eurozone, and strews Europe with little shadowless bushes,



creating a hot house for national resentments. The Euro-sceptical Chancellor Merkel and her government would do well to learn from Chancellor Kohl and, like him, reconcile allegiance to Germany with loyalty to Europe.

The book starts with an overview of the economic analytical framework concerning the theory of currency areas. In the 1960s, the theory of OCAs emerged as a by-product of the theoretical debate between fixed and flexible exchange rates. The *OCAs approach* singles out an economic characteristic to define an economic domain where there is exchange rate fixity *erga intra*, while there is exchange rate flexibility *erga extra*. In an optimum currency area, exchange rates fixity prevails internally without any type of internal or external disequilibrium. Each single characteristic ensures that floating or regular adjustments in nominal exchange rates are *neither necessary nor efficient or desirable* for stabilisation purposes.

The literature proposes several economic criteria: factor mobility (Mundell); openness of the economy (McKinnon); product diversification (Kenen); national propensity to inflate (Magnifico); financial integration (Ingram); real exchange-rate changes (Vaubel). While the *cost-benefit approach* considers OCAs criteria for guaranteeing long-term equilibrium, this approach is operational and focuses on the political commitment of countries to form a monetary union assessing the resulting costs and benefits. Benefits are associated to efficiency and price stability gains, risk reductions arising from exchange rate uncertainty, and gains from using the euro as a reserve currency; while costs relate to the loss of monetary independence, diverging preferences in national inflation-unemployment relationship, and worsening regional disequilibrium.

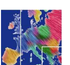
If countries find difficult sometimes to abandon their respective exchange rates as a device for correcting their external imbalances, ¿why is it the case that regions of a country are tempted to leave the nation-wide currency areas and launch its own regional currencies? To answer this question is devoted the second chapter of the book, in which the economic rationale of fiscal rules in OCAs, that is the Stability and Growth Pact (SGP) and the Excessive Deficit Procedures are subject to analyses.

The chapter also examines the case of regions of national country that consider a good idea to remain part of such a wider country and to share a common currency, despite the fact of showing diverging trends in unemployment, inflation rates, wages, non-wage costs, and productivity trends. This compares with the case of a group of EU countries with decentralised national budgets within a monetary union facing asymmetric shocks. As the latter economic context requires some fiscal commitments from national governments, we analyse the economic rationale of setting fiscal rules under a common currency area and the resulting EU institutional frame for the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP). We discuss the legal basis for the EDP and the relevant accounting definitions. We also provide the initial settings of the SGP, as well as a summary of the contents and the related assessment of the revised SPG in March 2005. We conclude the chapter with a brief comment on the so-called "Six Pack" adopted by the EU in December 2011, which provides a wide range of macroeconomic indicators to improve the governance of EMU within eurozone countries, through the Surveillance of Macroeconomic Imbalance Procedure.

The above macroeconomic imbalances result from asymmetric shocks within the Eurozone and call for an enhanced role of labour market flexibility. This is dealt with in chapter 3, which discusses the economic conditions for the success of EMU when there is still a need for structural reforms in the markets of goods and services, and factors of production. In view of asymmetric shocks, experience shows that behaviour in nominal and real wage growth resulted in increased unemployment over the EU15. Fiscal policy, on the other side, could mitigate to some extent the burden of wage adjustment, and could play an important role at improving productivity.

In general, however, smooth shock-absorption requires a flexible wage formation process to circumvent low employment levels, but the risk of hysteresis would remain. To avoid the accumulation of wage and labour cost differentials, which finally result in a widening external cost-competitiveness divergence among eurozone countries, wage bargaining behaviour should respect at least several rules. These norms for wage developments are the following: (i) maintain overall nominal wage developments consistent with the goal of price stability; (ii) keep real wage developments in line with productivity increases; (iii) avoid wage demands to converge upwards and to catch up with wage increases in neighbour countries; and, (iv) wage agreements should also better take into account productivity differentials according to qualifications, skills and geographical areas.
A flexible labour market, however, does not refer exclusively to hiring and firing conditions, as the narrow OECD approach to labour market flexibility considers. This is why the following chapter addresses the issue of labour market *flexicurity* in the eurozone, and discusses the evolution of the idea of flexible labour market as a smooth shock absorber in case of asymmetric shocks. The concept of flexible labour markets became an institutionally well-settled concept when the OECD constructed its index of labour market strictness. The OECD recognised, however, the weakness of its narrow approach and the European Commission put forward a more novel notion of *flexicurity*.

In my turn, the personal proposal of the concept of *flexicurity* aims at reaching a reasonable agreement on both the efficiency and the security principles by taking into consideration the interest of all the stakeholders in the



labour market, including those inactive or in unemployment. Further, we provide a wide overview of the several approaches concerning the issue of flexible labour markets. We also developed a thorough analysis of the implementation of the notion of *flexicurity* in several EU Member States such as Denmark, The Netherlands, Austria, and Spain. In the case of Spain, we verify the few elements of *flexicurity* contained in the Spanish labour market reforms during the 1980s and 1990s, as well as in the most recent reforms during the 2010-12 period.

The two last chapters of the book jump onto both the Spanish and the eurozone domestic crisis. The former was the result of the housing market bubble and huge external disequilibria, and chapter 5 recalls the major issues at stake in the Spanish economy since 1996, a time when financial markets started to discount the Spanish entry into the eurozone. We start with a summary analysis of the most recent economic developments, and the current macroeconomic imbalances. As from 2007, the Spanish economy underwent the worst period in the recent history since the Stabilisation Plan implemented in 1959.

In 2008, what was most worrying, however, was the perception of disorder transmitted by the Government: they limited themselves to take measures against the global financial crisis pretending this was the major and unique problem to cope with. On the contrary, the very problem in 2008 consisted in the downward shift of the potential productive capacity of the Spanish economy, we became poorer and we should have reacted on it. In 2008, we faced a domestic crisis not an external macroeconomic shock, despite the fact that citizens did not feel fully the pain of the forthcoming macroeconomic adjustment. Inaction in the economic field translated into major macroeconomic imbalances: huge external deficit, over-dimensioned and undercapitalised sectors (housing, banking), and lack of structural reforms in sectors (banking, labour market, and health) and policies (fiscal and budgetary).

The chapter 6 provides a diagnosis of the financial crisis and provides a Spanish perspective, yet, it remains within a balanced European approach. The analysis undertaken aims at avoiding, as much as possible, an economic though ideologically guided and the respect of *good economics*. The crisis of the euro became self-evident after the financial markets turmoil, which took place during the summer 2007. The global financial crisis cast serious doubts about some dogmas put forward by the defenders of the libertarian capitalism, as the one on the efficiency of financial markets. Whereas in the US several episodes of bankruptcy took place within banks, in the EU the banking sector was recapitalised, fiscal measures were taken to support companies and families, and to stimulate the economy; moreover, an institutional framework was set up to improve the financial regulation and supervision. The banking and financial crisis was followed, as usual, by a debt crisis. In 2010-2011, successive European Summits accelerated the building up of financial facilities and rescue mechanisms to finance countries facing difficulties and to avoid the contagion effect. Political attention focussed on those funds, hiding the political nature of the euro crisis, and masking the exchange rate and balance of payments disequilibria in the eurozone.

This last chapter emphasises monetary cooperation between Member States of the eurozone cannot be imposed through mere compulsory rules. It also requires mutual trust, a *quid pro quo*. The new budgetary rules, as they do not tackle the very core of the problem – exchange rate misalignments and balance-of-payments disequilibria –, will neither remove the doubts nor the anxiety of investors. A serious progress towards a *fiscal union* would require:

(i) a greater coordination of fiscal policies between Member States;

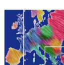
(ii) a larger size and larger redistributive capacities of the EU budget to make it able to fulfil properly its macroeconomic stabilising function. We the Europeans need a common budget with the required minimal size as to be used by the ECOFIN as countercyclical macroeconomic policy device;

(iii) the introduction a genuine European tax, to increase the own resources of the EU, even though this idea is resisted by the German and French, which refuse to increase their respective EU contributions; and,

(iv) transfers of European funds towards less favoured regions, through investments, trans-European net works and infrastructures, etc. (European Commission 1993, 75-85]. These resources, channelled through the EU Budget, could be complemented by credits from the European Investment Bank (IEB) and the European Investment Fund (EIF). The latter brings us to the hot debate on a *union of financial transfers*, an issue politically unacceptable to both Chancellor Merkel and the German public opinion, which unveils why the crisis of the euro is political and not economic in nature.

To correct the macroeconomic imbalances, beyond enhanced capital transfers from the EU budget to the peripheral countries, would require continue internal devaluations of the peripheral countries, and internal revaluations in the core countries, namely in Germany. Finally, the chapter proposes alternative scenarios to save the Eurozone from collapse. Indeed, with no adjustments in nominal exchange rates, external disequilibria in the eurozone can only be achieved through changes in relative prices and costs, therefore, *several alternative scenarios emerge*:

(i) *capital transfers via the EU budget*: this possibility would correct the disequilibria in the long-term, but is politically unacceptable to Germany given the huge amount of resources that this would involve;



(ii) *internal devaluations of the peripherals combined with internal revaluations in the core countries*: on the one side, through a reduction in the absorption of the peripheral economies, which will bring about a containment, or reduction, in the prices of goods, services and assets, which has already started, but has severe limits; and, on the other side, by means of a wage expansion in the surplus countries;

(iii) *accommodating monetary and euro depreciation policies on behalf of the European Central Bank*: this would produce higher inflation pressures in core countries than in the periphery. The prices of goods and services will increase more rapidly in the core than in the periphery absorbing the external deficit of the former and reducing the deficit in the later, which would avoid the dangers and costs of deflation. Central countries will suffer the economic costs of inflation and will see its savings penalised as the banks and households will recover their holdings of sovereign debt in devalued terms, better than suffering a haircut or not recovering it at all. Moreover, the costs of inflation would have the advantage of not being self-evident and distributed over time; and,

(iv) *Combining the previous three*: this could probably be the most plausible scenario, and it would combine capital transfers through the EU budget, internal devaluation of the peripherals and internal revaluation in core countries by wage increases; in the case of Germany they could re-introduce subsidies to imports and taxes to exports as they already did in 1964, to penalise the exorbitant profits of exporting industries instead of putting the whole burden on the German taxpayer; it far from being ideal, but it would redistribute the burden of adjustment in the eurozone in a more equitable way, until the new Treaty comes into force.

A part from the above economic proposals to solve out the current eurozone crisis, some additional conclusions, more political in nature, emerge from the book:

(i) Core countries, and more particularly the German authorities, have to understand that no country escapes undamaged from a eurozone in crisis. There is not such a thing as a free lunch in economics, neither for Germany. All of them, however, have a cost that Germany cannot escape. The first would consist to mobilise the excess of savings by implementing a *wage expansion*, that is, an increase in labour costs whether wages and/or non-wage costs. A wage increase would expand the German domestic demand, and part of this expenditure would filter to imports from the eurozone and would be growth supportive, whereas an increase in social security charges would strengthen the generosity of the German social protection schemes.

(ii) In contrast to the *fiscal expansion* proposed time ago by Martin Wolf, the *wage expansion* would not penalise the German taxpayer, but the export-oriented German companies which would have to either increase prices and loose competitiveness, or maintain the competitiveness by squeezing the profit margins that are nowadays exorbitant, a detail that the German authorities do not underline quite often. More inflation would reduce the external surplus and stimulate growth, something that would contribute both to alleviate the periphery debt payments, and to fade away the risk of insolvency that the German banks may fear on the debt holdings that they have in their respective balance sheets.

(iii) There is need to rescue the EU from the trap of the intergovernmental and post-democratic exercise of power in which has fallen. The latter would favour the come back of the so-called *méthode communautaire* to help construct Europe as a transnational democracy.

(iv) There is a need to legitimate the political decisions with regard to Europe through both the National and the European Parliaments, as well as by means of the European Court of Justice.

(v) It is imperative to swerve the present economic and financial fragmentation of Europe.

(vi) There is a need to end up with the German intransigence, which takes root in the re-unification, which allows the German elites to fully exploit the advantages of a brand-new national State.

(vii) The sixth and last challenge lies on the German determination to look Eastern. In this respect, Habermas is right when states "The Republic of Berlin […] forgot the lessons that the Federal Republic learnt from history". The new German strategic-political course weakens the German commitment with the European construction, undermines the credibility of the German political support to the current political initiatives to complete the eurozone, and sows Europe with little bushes without shadow, with future national resentments. The euro-sceptical Chancellor Merkel and her Government should better learn from Chancellor Kohl and, like him, reconcile the fidelity to Germany with the loyalty to Europe.