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Europe – Driver or Driven?
EMU and the Lust for Crisis
ACI Congress, May 30, 2008



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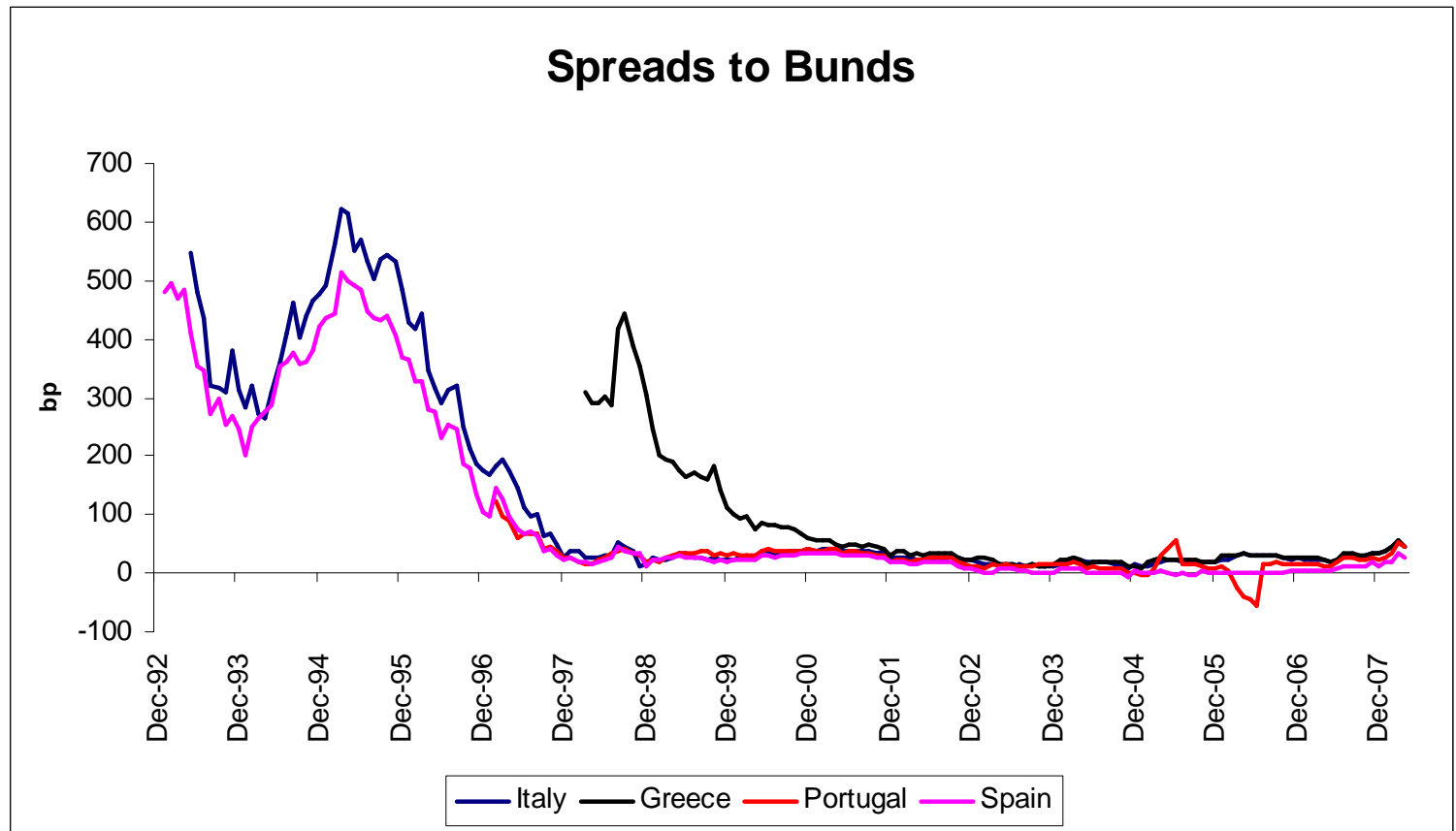
What Europe Wants

- **To use global issues as excuses to extend its power:**
 - environmental issues: increase control over member countries; advance idea of global governance**
 - terrorism: use excuse for greater control over police and judicial issues; increase extent of surveillance**
 - global financial crisis: kill two birds (free market; Anglo-Saxon economies) with one stone (Europe-wide regulator; attempts at global financial governance)**
 - EMU: create a crisis to force introduction of “European economic government”**

The Global Economic Crisis and the EMU Crisis

- The global crisis is the result of intertemporal misallocation (Greenspan; EMU).
- In effect, there has been a global Ponzi game.
- In Europe, this was intensified by the myth that “current accounts don’t matter in a monetary union”: EMU is the biggest credit bubble of them all.
- The treaty says that government should have the same credit status as private sector borrowers.
- Monetary union means greater economic instability.
- These two factors should mean a worsened credit standing in EMU, yet government bond spreads actually diminished in EMU and ratings agencies actually upgraded governments.

Bond Spreads in EMU

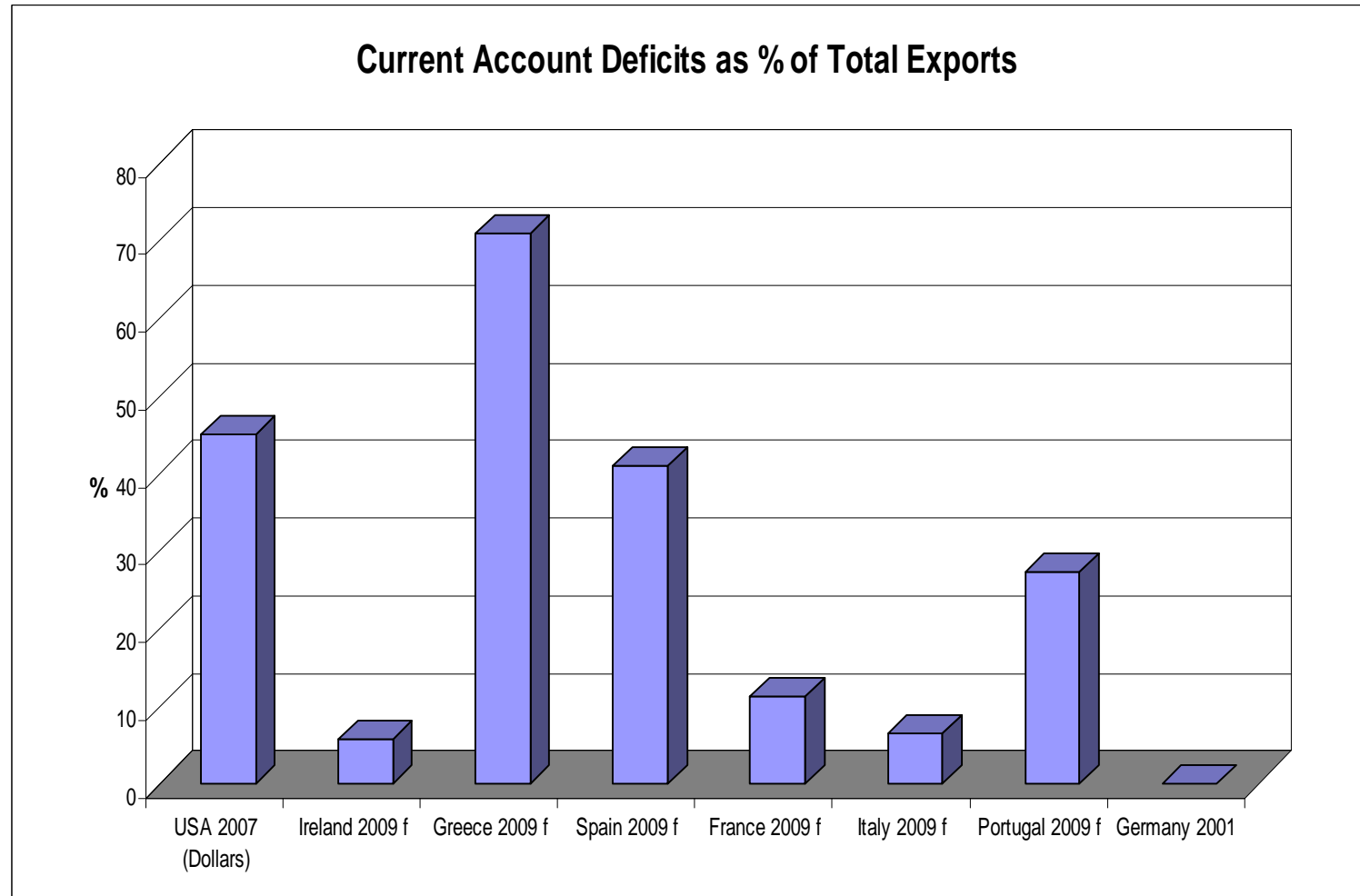


Source: Bloomberg

When the bubble bursts...

- A collapsing credit bubble in the world means collapsing domestic demand in deficit countries (e.g. US, Britain, Balkans, Baltics – and several euro-area countries)
- In the US, and to some extent Britain, domestic demand is being supported by rate cuts and, in the US, by a fiscal stimulus
- In the affected euro-area countries, it isn't
- In the absence of support for domestic demand, affected countries will be forced into an improvement in net exports via improved competitiveness
- In the US and Britain, this is happening through currency depreciation; in the euro area it isn't.

Current account imbalances in euro area rival the US



Source: Eurostat

And the implied real exchange rate movements are enormous...

- Obstfeld and Rogoff saw a need for perhaps a 65% real effective exchange rate move for the US if current account adjustment were sudden (e.g., after a housing collapse).
- The effect is linear in the size of the current account deficit relative to the size of the traded goods sector, so for the four large euro-area deficit countries we get the required real exchange rate movements as:
 - -- Greece: 94%
 - -- Spain: 55%
 - -- Portugal 36%
 - -- Italy: 9%
 - -- France 15%

...meaning huge required inflation differentials between blocs within the euro area

- If the ECB tries to avoid depression in the deficit bloc (i.e., keeps its inflation rate at, say, 3%) and the deficit countries as a bloc (equivalent to about 2/3 of euro-area GDP) have to improve competitiveness by, say, 30%, over a five-year period, then that would involve euro depreciation of 50% and (with 1/3 pass-through into German Bloc CPI) *a rise of 17% (almost 3½% a year) German Bloc price level, taking German Bloc inflation to around 6½% for five years.*
- If instead the ECB tried to keep euro-area inflation at 2% (and no change in the euro), all the competitiveness change would have to come from Latin Bloc deflation; that would almost certainly involve a horrible depression, financial chaos, widespread default, social distress and possibly political instability.
- But this would mean substantial euro-area deflation, too, so hitting the euro-area target must involve substantial euro depreciation and a substantial increase in German Bloc inflation.
- These are all first-round calculations – they do not take account of wage-price spirals in the German Bloc as economies overheat.

Things are even worse for individual countries

- **If the ECB decides to avoid depression, deflation and default in the weakest country (Greece), the required depreciation of the euro would be enormous and German Bloc inflation would be well into double digits for several years.**
- **If weak countries have, individually, little political influence, it will be hard for them to get the ECB to bail them out via low interest rates and a weak euro.**
- **But if there is no ECB bailout, vulnerable economies face catastrophe.**

Is there an other way out?

- **Current account deficits can be closed without a corresponding reduction in the trade deficit if current transfers are big enough.**
- **The treaty prohibits a takeover of a country's public debt, but does not prohibit additional transfers to support private spending.**
- **The ECB is in effect already helping some banking systems by accepting increasingly risky collateral (but note that this may be helping German, Dutch/Belgian banks as well as, say, Spanish banks – note public disagreement between Mersch and Weber).**
- **But the numbers involved in a complete fiscal bailout would be staggering: eliminating current-account deficits within the euro area by fiscal bailouts would require the surplus countries (the German Bloc) to make payments equivalent to *16% of their total government revenues (7% of their GDP)*.**

How do markets react?

- The cost to the German Bloc of avoiding catastrophe in the weak countries would be very substantial indeed : either prolonged high inflation or very large, *permanent* transfers.
- In the end, this may be what happens, given the grandiose geopolitical ambitions for “Europe”.
- But there can be no certainty about that; so the other alternatives – catastrophe in weak economies, almost certainly involving widespread default and severe strains on banking systems, or EMU withdrawals must have non-negligible probabilities.
- Given that, once the market comes to understand the choices, the risk of a sudden funding run on banking systems in weak economies is very real – hence the build-up of “war chests” of dubious collateral for ECB refinancing.