

# What Have we Learnt about Monetary Integration.

Prof. Carlos San Juan Mesonada

**Readings:**

- 1) PAUL DE GRAUWE, 2006 What Have we Learnt about Monetary Integration since the Maastricht Treaty? JCMS 2006 Volume 44. Number 4. pp. 711–30
- 2) PAUL DE GRAUWE AND YUEMEI JI, Social Europe Journal 25/02/2013 Panic-driven Austerity In The Eurozone And Its Implications

# Monetary policy in the EMU

## The Commission's view

- **EMU**, European Monetary Union (1999)
- Fix exchange rate
- **ECB**, European Central Bank
  - Single monetary policy
  - The euro is the **single currency shared by 19** of the 26 **MS, Member States**
  - **The euro is not the currency of all EU Member States.**
    - Two countries (**Denmark and the United Kingdom**) have 'opt-out' clauses in the Treaty exempting them from participation, while the remainder (several of the more recently acceded EU members plus **Sweden**) have yet to meet the conditions for adopting the single currency.
  - Andorra, Monaco, San Marino and the Vatican City have adopted the euro as their national currency by virtue of specific monetary agreements with the EU, and may issue their own euro coins within certain limits. However, as they are not EU Member States, they are not part of the euro area.
  - See: [http://ec.europa.eu/economy\\_finance/euro/index\\_en.htm](http://ec.europa.eu/economy_finance/euro/index_en.htm)
  - **Fiscal and structural policies** remain in the hands of individual **national authorities**.
    - However, they **must coordinate these policies** in order to attain the **common objectives of stability, growth and employment**.
    - A major coordination structure is the [Stability and Growth pact](#), which contains agreed rules on fiscal discipline.

# What started as a banking crisis became a sovereign debt crisis/1

- i. Europe's debt crisis was initially triggered by events in the American banking sector.
- ii. **Deregulation in the US financial sector, main cause.**
- iii. When a slowdown in the US economy caused **over-extended American homeowners** to **default on their mortgages**, banks all over the world with **investments linked to those mortgages** started **losing money**.
- iv. America's fourth largest investment bank, **Lehman Brothers**, **collapsed under the weight of its bad investments**, **scaring other banks and investors** with which it did business.
  - i. The fear that more banks could fail **caused investors and banks to take extreme precautions**.
  - ii. **Banks stopped lending to each other**, pushing those reliant on such loans close to the edge.
- v. **European banks** that had invested heavily in the American mortgage market **were hit hard**.

# What started as a banking crisis became a sovereign debt crisis/2

- I. In an attempt to stop some banks from failing, **governments came to the rescue in many EU** countries like Germany, France, the UK, Ireland, Denmark, the Netherlands and Belgium. Also in Spain, Italy and Portugal.
- II. **But the cost of bailing out the banks proved very high.**
  - i. In **Ireland**, it almost bankrupted the government until fellow EU countries stepped in with financial assistance.
- III. As Europe slipped into recession in 2009, **a problem that started in the banks began to affect governments** more and more, as markets **worried that some countries could not afford to rescue** banks in trouble.
  - i. Investors began to look more closely at the finances of governments.
  - ii. **Greece came under particular scrutiny** because its economy was in very bad shape and successive **governments had racked up debts** nearly **twice** the size of the economy.
  - iii. Other MS suffer contagion and become suspicious: Ireland, Spain, Italy and Portugal
- IV. **The threat of bank failures meant that the health of government finances became more important than ever.**
  - I. Governments that had grown accustomed to borrowing large amounts each year to finance their budgets and that had accumulated massive debts in the process, suddenly found **markets less willing to keep lending** to them.

Source: EU Commission, 2015

See: Panic driven austerity for a critical view of the Council response to the debt crisis in 2010.

# Governance in the EMU/1

- What started as a banking crisis became a sovereign debt crisis.
- Stability and Growth Pact show several shortcomings.
- The debate about the governance in the EMU was re-open in the academic and political field

**Which theory better explain the real world?**

# Governance of the EMU/2.

## Introducing, the Degrauwe point of view

- The present governance of the euro area has been devised assuming that the world fits the **monetarist-real-business-cycle theory**.
- But that theory is not a correct representation of the world.
- The European monetary union is a remarkable achievement, but remains **fragile** because of the **absence of a sufficient degree of political union**
- **What have we learnt since the Treaty was signed?**

# I. Mundell I and Mundell II

- At the time of the signing of the Maastricht Treaty, the economic profession was still struggling with the **pros and cons of monetary union**.
- **Delors report**: provided the intellectual basis of the Maastricht Treaty (1991).
- At the time there were really two theories competing for academic attention, with very different policy implications.
  - **Mundell I (OCAs)** provided the basis for widespread **skepticism about the desirability** of a monetary union in Europe
  - while **Mundell II** was used by the proponents of monetary union (The **Delors report**).

# Optimal currency areas (OCA)

- The OCA theory determines the *conditions* that countries should satisfy to make a monetary union *attractive*,
- i.e. to ensure that the **benefits** of the monetary union **exceed its costs**.
- The conditions that are needed to make a monetary union among candidate
- Member States attractive can be summarized by three concepts:
  - **Symmetry (of shocks)**
  - **Flexibility**
  - **Integration**



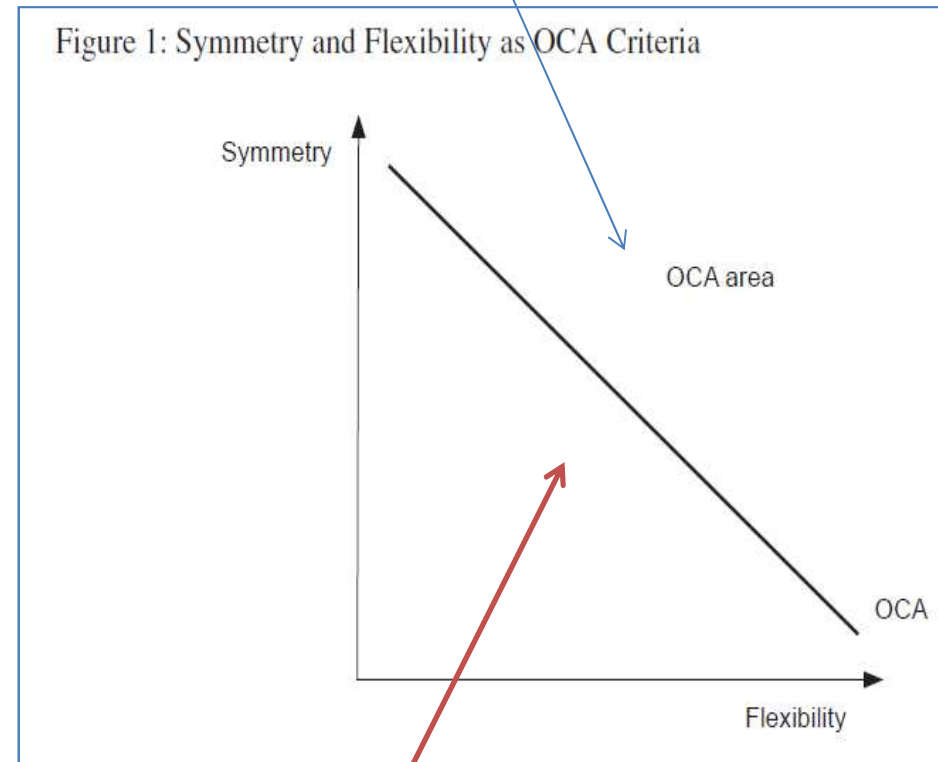
# Symmetry and flexibility in OCAs

**Figure 1** presents the minimal combinations of symmetry and flexibility that are needed to form an optimal currency area by the downward-sloping OCA line.

**Points on the OCA** line define combinations of symmetry and flexibility for which the costs and the benefits of a monetary union just balance.

It is **negatively sloped** because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility.

To the right of the OCA line the degree of **flexibility is sufficiently large** given the degree of symmetry to ensure that the benefits of the union exceed the costs.



To the left of the OCA line there is **insufficient flexibility** for any given level of symmetry.

# Symmetry and integration in OCAs

**Figure 2** presents the minimal combinations of symmetry and integration that are **needed to form an optimal currency area, OCA**.

The OCA line represents the **combinations of symmetry and integration** among **groups of countries** for which the cost and benefits of a monetary union just **balance**.

**It is downward sloping for the following reason:**

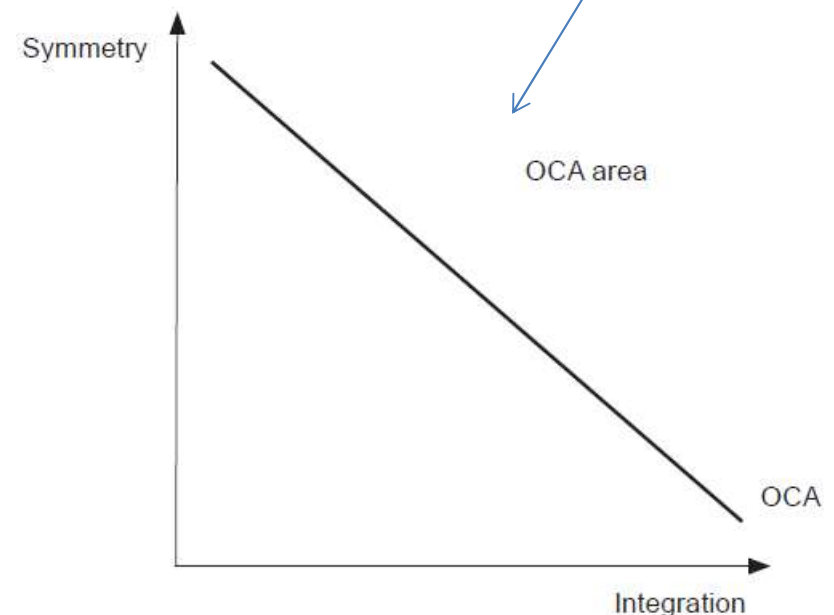
- A **decline in symmetry raises the costs** of a monetary union.
- These **costs** are mainly **macroeconomic** in nature.

**MS benefit from the efficiency gains of a monetary union.**

Thus, the additional (macroeconomic) **costs produced by less symmetry** can be **compensated by the additional (microeconomic) benefits** produced by more integration.

Points to the right of the OCA line represent groupings of countries for which the **benefits of a monetary union exceed its costs**.

Figure 2: Symmetry and Integration as OCA Criteria



# Mundell II (1973)

- The new Mundell (**Mundell II**) starts from the situation of a world of **free mobility of capital**;
- In a world of free mobility of capital, the **exchange rate ceases to be a stabilizing force**.
- Instead, according to Mundell II, the exchange rate becomes **a target of destabilizing speculative movements** and thus a **source of large asymmetric shocks**.
- Thus, the view of Mundell I implying that the **exchange rate could be used to stabilize** the economy after an **asymmetric shock** should be **abandoned**.

# Mundell II (1973)/2

- In the world of Mundell II **joining a monetary union** should not be seen as a cost arising from the loss of the exchange rate as an adjustment mechanism, but as a **benefit of eliminating a source of asymmetric shocks**.
- For most countries, the exchange rate does **not provide a degree of freedom**
  - but uses up a degree of freedom in their economic policy since they have to stabilize this asset price.
  - Mundell II is based on the idea that **foreign exchange markets are not efficient** and should not be trusted to guide countries towards macroeconomic equilibrium
  - This view has received **increased empirical backing**.
  - exchange rate is **disconnected most of the time from its fundamental value**

(see De Grauwe and Grimaldi, 2006, for evidence and implications of these findings).

# Mundell II became a major promoter of monetary union/3

There is a second insight in Mundell II:

1. Only in a monetary union can capital markets be **fully integrated** so that they can be used as an **insurance mechanism against asymmetric shocks** (see Asdrubali et al., 1996).
2. When countries remain outside a monetary union they **cannot hope to profit from insurance** against asymmetric shocks provided by capital markets in the rest of the world.
  1. The reason is that the large and **variable exchange risk premia** **prevent these capital markets** from providing insurance against asymmetric shocks.
  2. Thus the world of Mundell II is one in which countries that stay **outside a monetary union** will have to deal **with large asymmetric shocks** that arise from **the instability of international capital flows**.
  3. These countries' ability to insure against traditional asymmetric shocks is **severely restricted** when they stay **outside a monetary union**.

# Maastricht Treaty & academic economists' minds

## Mundell II/4

- At the time the Maastricht Treaty was signed, most academic economists' minds were framed by Mundell I and scepticism about the prospects of a monetary union was widespread.
- In the end Mundell II prevailed.
- **Why did this happen?**
- There was first the **collapse of the EMS** in 1992–93.
  - This historical episode made clear that in a world of free mobility of capital, **fixed exchange rates were unsustainable** as long as central banks maintained their own independent monetary policies.
  - The EMS-crisis convinced many continental European economists that a choice had to be made for one of the two 'corner solutions' in exchange rate regimes, i.e. **full flexibility of exchange rates** or **monetary union**.
  - Many decided that the latter would be **the least bad choice**.
  - **Mundell II triumphed** on the European continent.
  - **But still no so popular in the US academic mind's in 1999**

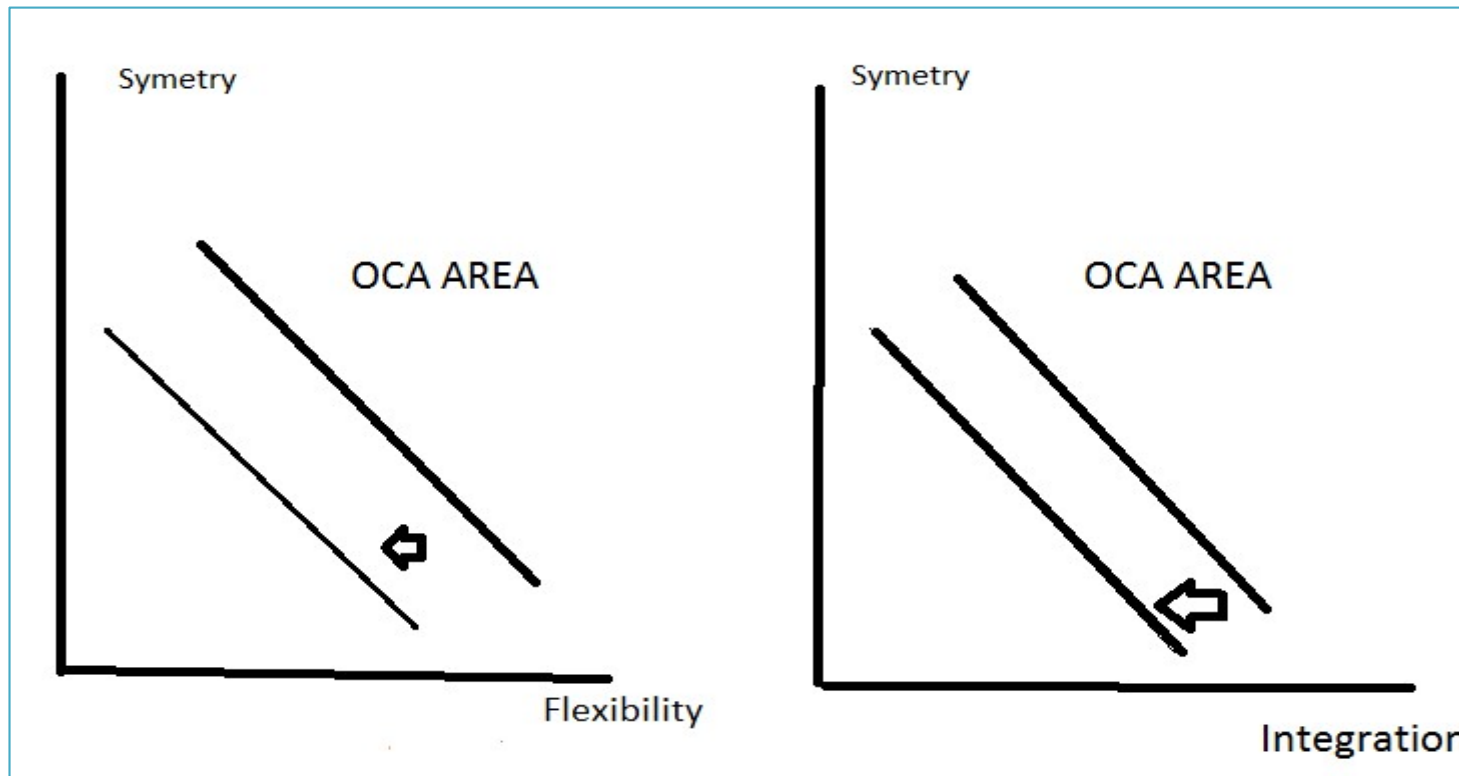
# Mandell II and Monetarism/5

- Monetarism, instead, stressed that **activist monetary policies** become **sources of instability** and
- that central banks **should focus** on their core business which is **to maintain price stability**.
- The logical consequence of monetarism was the view that central banks **do not lose their capacity to stabilize** their national economies when **entering a monetary union**, since **they did not have such a capacity** in the first place.
- In this monetarist vision (and Mundell II was also an outgrowth of monetarism) the **costs of a monetary union are small**.

# Mandell II and Monetarism/5

costs of a monetary union are small

- In terms of our Figures 1 and 2, the OCA line is located very close to the origin. The OCA-region is a vastly expanded one.





# Mundell II, asymmetric shocks

A number of countries in EMU have recently experienced large losses of competitiveness: an asymmetric shock

- The Great Recession of 2008 was an asymmetric shock
- This phenomenon will lead to the need to adjust in many countries.<sup>2</sup>

**In particular, the countries that have lost competitiveness will have to restore it.**

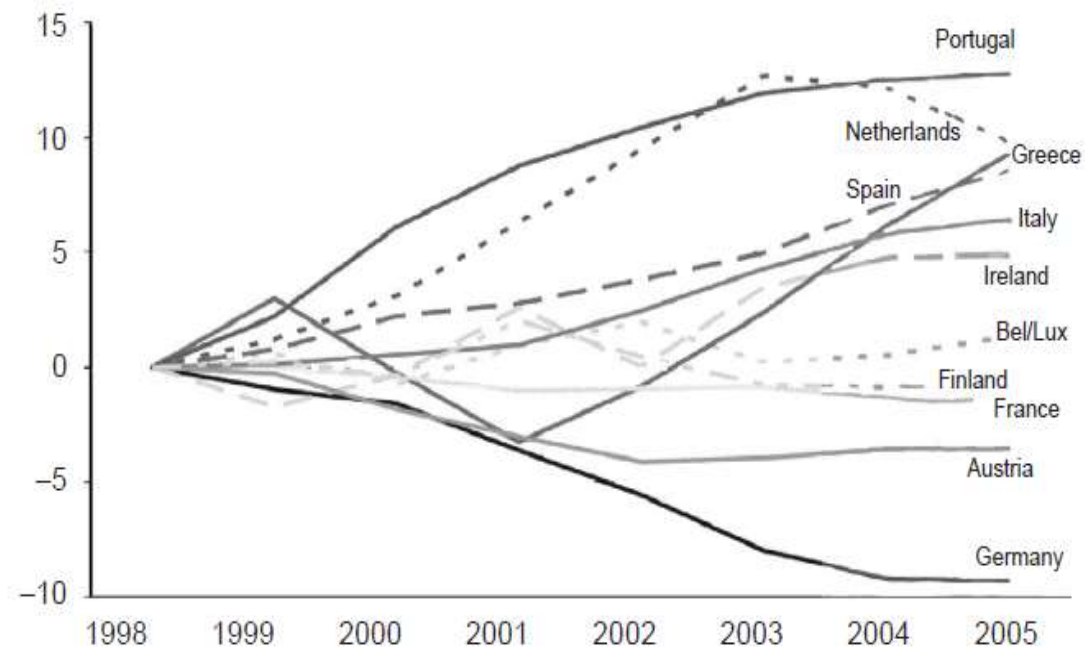
- In a monetary union this **can only come about by having lower rates of price and wage inflation than the average** of the euro area.
- However, since the ECB is targeting a rate of inflation below 2 per cent, the countries that have lost competitiveness will find it **very difficult to lower their inflation** rates below the euro area average **without introducing outright deflation**, and large increases in **unemployment**. [like in Spain after 2010]

# Real Effective Exchange rate

**Figure 3:** The striking fact is the extent to which yearly inflation differentials have led to sustained changes in these real exchange rates. As a result of these trends, some countries (Portugal, Netherlands, Spain and Italy) **have lost a significant amount of price competitiveness.**

Others, like Germany and Austria **have gained a significant amount of price competitiveness.**

Figure 3: Intra-Euro Area Real Effective Exchange Rates (Based on Unit Labour Costs)



Source: Commission (2005).

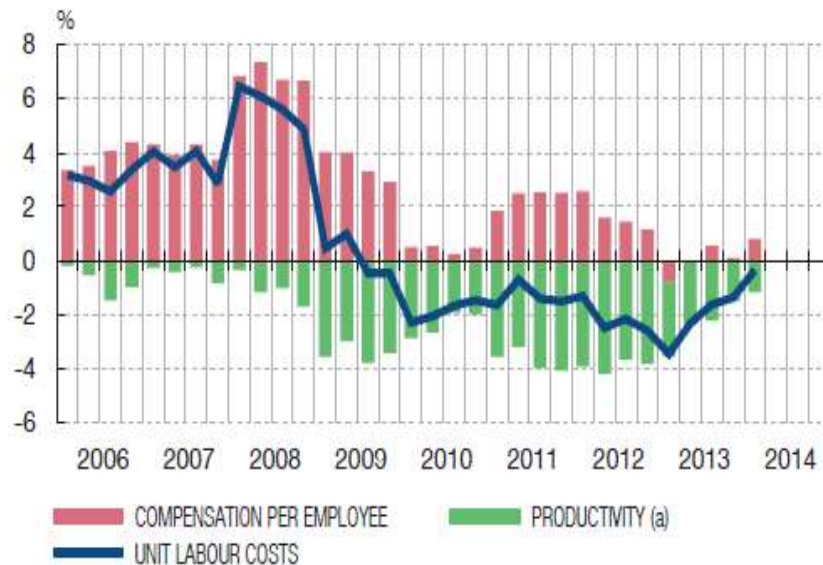
<sup>2</sup> Since the real exchange rates used here are based on unit labour costs, they take into account differential productivity growth. As a result divergent movements in these rates cannot be the result of the Balassa-Samuelson effect (see also Gros *et al.*, 2005).

# Inflation Gap

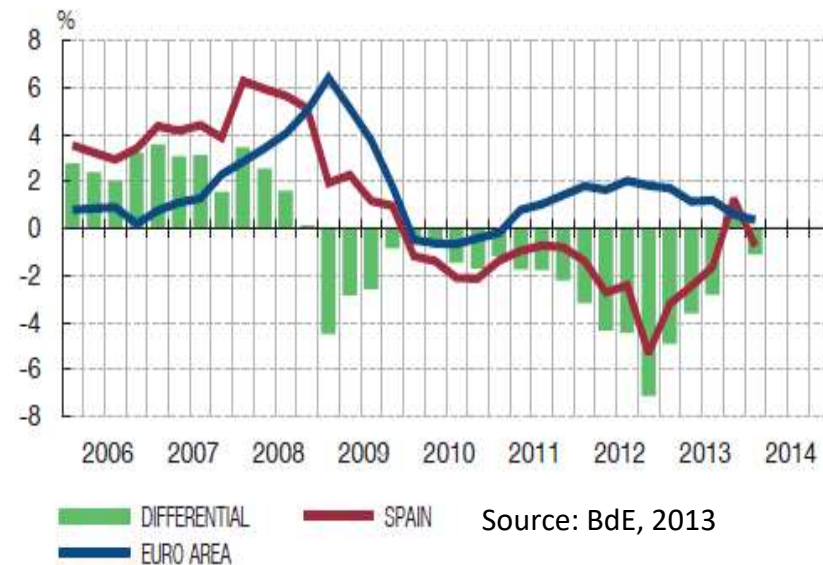
## LABOUR COSTS AND INFLATION

CHART 1.7

MARKET ECONOMY UNIT LABOUR COSTS  
Year-on-year rate



SPANISH AND EURO AREA UNIT LABOUR COSTS  
Year-on-year rate



It can be argued (Degrauwe, 2006) that,

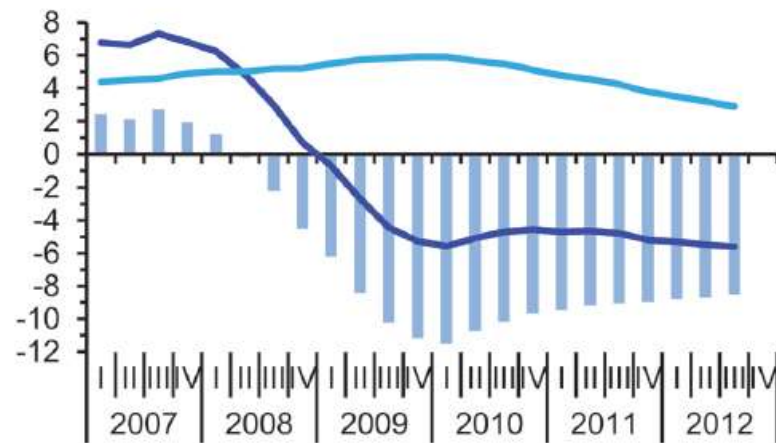
- by making it **more difficult for countries to restore their lost competitiveness**, the **low inflation target** of the ECB introduces a **powerful rigidity** in the euro area.
- Thus **paradoxically a higher inflation target would introduce more flexibility**.
- It would also **lead to less tension** within the euro area.

# Deficit expansion in Spain after the great recession of Sept.-08

Exhibit 2

## General government saving, investment and deficit (1)

Percentage of GDP, moving sum over four quarters



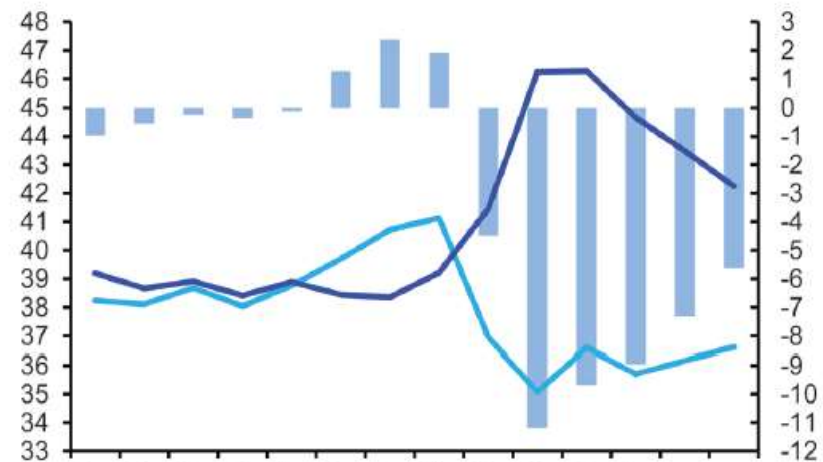
(1) Excluding aid to financial institutions.

- Net lending (+) or net borrowing (-)
- Saving (current income less expenses)
- Capital expenses

Exhibit 3

## Government income, expenses and deficit (1)

Percentage of GDP



(1) Excluding aid to financial institutions.

- Deficit / Surplus (right)
- Income (left)
- Expenses (left)

Source : FUNCAS, SEFO, Nº 5, 2013

# Assessing the sign of budgetary policy and fiscal consolidation in Spain

(Austerity policy means -1.7 pp of GDP in 2012 excluding support to financial institutions)

Table 5

## Breakdown of government deficit

	2006	2007	2008	2009	2010	2011	2012 (F)	2013 (F)
Percentage of GDP								
1.- TOTAL DEFICIT	2.4	1.9	-4.5	-11.2	-9.7	-9.4	-8.4	-5.6
2.- Non-recurrent extraordinary expenses (a)	0.0	0.0	0.5	1.2	1.0	0.5	1.1	0.0
3.- Interest payments	1.6	1.6	1.6	1.8	1.9	2.5	3.2	4.1
4.- Recurrent primary deficit (1+2+3)	4.0	3.5	-2.4	-8.2	-6.7	-6.5	-4.1	-1.5
4.1.- Recurrent cyclical primary deficit	3.3	5.1	4.8	0.7	0.0	0.1	-1.4	-2.9
4.2.- Cyclically adjusted recurrent primary deficit (STRUCTURAL PRIMARY DEFICIT) (4-4.1)	0.7	-1.6	-7.2	-8.9	-6.7	-6.6	-2.7	1.4
5.- Cyclically adjusted total primary deficit (TOTAL STRUCTURAL DEFICIT) (4.2-3)	-0.9	-3.2	-8.8	-10.6	-8.7	-9.0	-5.9	-2.7
Change on previous year in percentage points of GDP								
1.- TOTAL DEFICIT	1.1	-0.4	-6.4	-6.7	1.5	0.2	1.1	2.8
2.- Non-recurrent extraordinary expenses	0.0	0.0	0.5	0.7	-0.2	-0.5	0.6	-1.1
3.- Interest payments	-0.1	0.0	0.0	0.2	0.2	0.5	0.8	0.9
4.- Recurrent primary deficit (1+2+3)	1.0	-0.5	-5.9	-5.8	1.4	0.2	2.4	2.6
4.1.- Recurrent cyclical primary deficit	1.9	1.9	-0.3	-4.1	-0.7	0.1	-1.4	-1.6
4.2.- Cyclically adjusted recurrent primary deficit (STRUCTURAL PRIMARY DEFICIT) (4-4.1)	-0.9	-2.3	-5.6	-1.7	2.2	0.1	3.9	4.1
5.- Cyclically adjusted total primary deficit (TOTAL STRUCTURAL DEFICIT) (4.2-3)	-0.8	-2.3	-5.6	-1.8	2.0	-0.4	3.1	3.2

(a) Includes both expenses and loss of income. In 2011 and 2012 these are aid to financial institutions. (F) Forecast. (a) Includes adjustment for uncertain collections.

Sources: Author's own calculations forecasts based on data from the National Accounts up to 2011. The output gap, which is the starting point for the estimate of the cyclical component of the deficit, is obtained as the percentage difference between actual and potential GDP. the latter is extracted using the Hodrick-Prescott filter ( $\lambda = 100$ ).

## II. Endogeneity of the OCA Criteria

- Frankel and Rose (1998) came up with the idea that the OCA criteria are endogenous. By that they meant that these criteria are affected by the very decision to start a monetary union.
- Thus countries that before the start of the union fail to satisfy the OCA criteria may, by the very fact that they form a monetary union, change economic conditions in such a way that these conditions get satisfied.
- **As a result the decision to start a monetary union has a self-fulfilling property.**
- By starting the monetary union the conditions that are favourable for a monetary union get satisfied, making the decision to form a monetary union the right one.
- **Conversely**, a decision **not to start a union** when the **conditions are not satisfied** helps to maintain **unfavorable** conditions so that **the negative decision also appears to have been the right one.**

## II. Endogeneity of the OCA Criteria/2

- There are different mechanisms that can make the OCA criteria endogenous.
  - 1) First, monetary union **can affect trade flows and intensify trade integration**, thus increasing the benefits of the monetary union.
  - 2) Second, monetary integration leads to more intense **financial integration** thereby facilitating the emergence of **insurance mechanisms** [e.g.: European Bank Authority, EBA].
    - a) The latter **reduce the costs of asymmetric shocks**.
  - 3) Third, a monetary union affects the functioning of the labor markets and can **potentially increase their flexibility**, thereby **reducing the costs of adjusting to asymmetric shocks** in the monetary union.

## II. Endogeneity of the OCA Criteria/3

- We show the effects of these mechanisms in Figures 4 and 5 which are the same as Figures 1 and 2.
- We have now put the euro area to the left of the OCA line, taking the view that when the euro area was started its members were not yet ready to form a monetary union.
- The endogenous mechanisms have the effect of moving the euro area towards the OCA area in Figures 4 and 5. This happens because monetary union increases the degree of economic (trade) integration (Figure 5).



# Symmetry & Flexibility: EMU

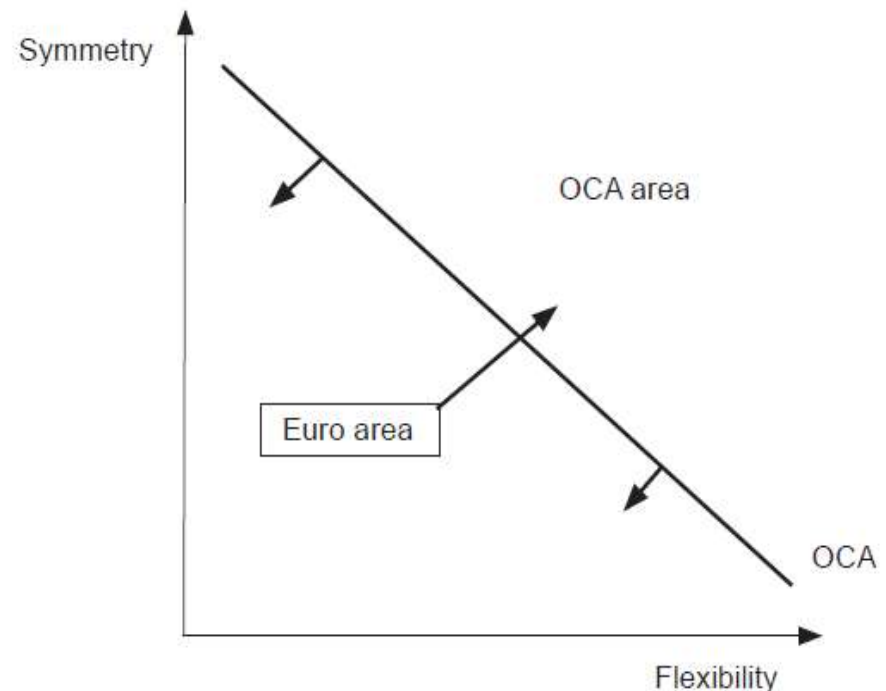
Is safe to conclude that a monetary union has a significant **positive effect on economic integration**, thereby moving the euro area towards the OCA area.

**What about flexibility?** If monetary union increases the pressure for **labor markets** to become **more flexible**

The **decision to enter** a monetary union also **improves the OCA criteria** tending to shift the euro area upwards towards the OCA area.

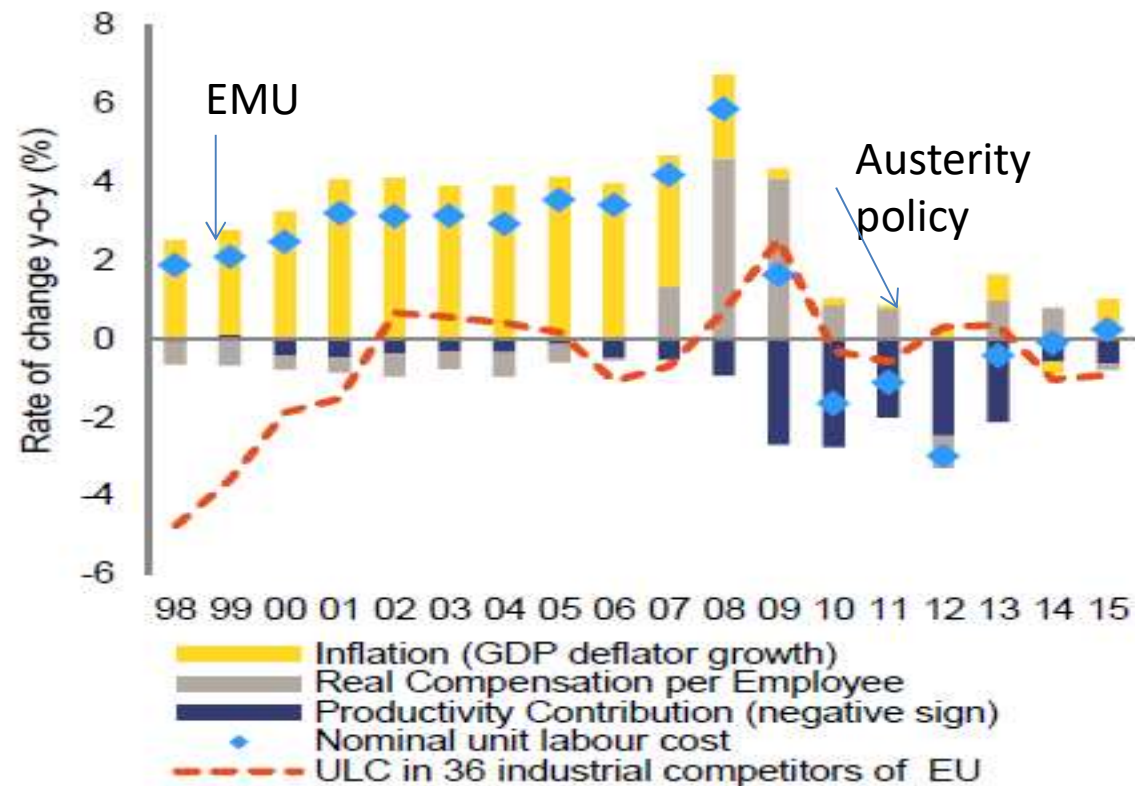
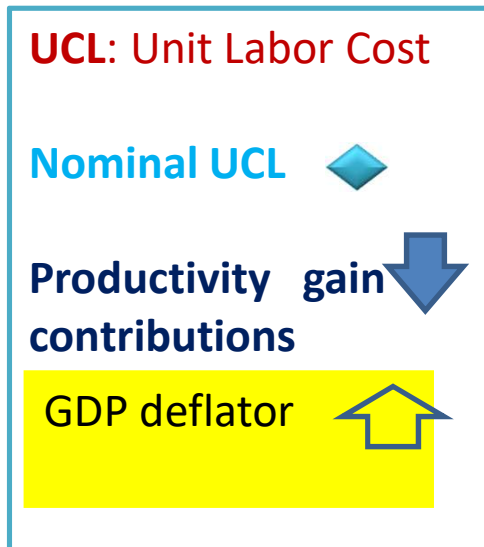
**It must be admitted that there is no consensus about this flexibility effect.**

Figure 4: Symmetry and Flexibility as OCA Criteria



# UCL: Unit Labor Cost Breakdown, Spain

Graph 1.4: Breakdown of the change of unit labour costs in Spain



Source: European Commission

# Unit labor cost in Spain

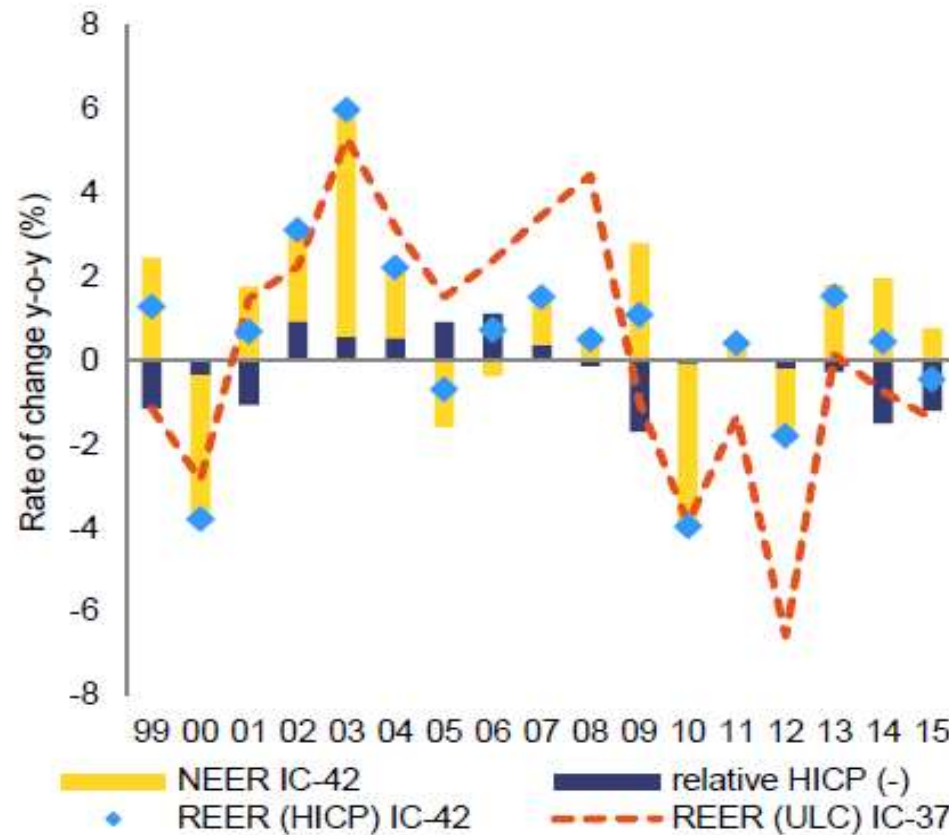
Graph 2.1.1: Evolution of price competitiveness in Spain

**UCL:** Unit Labor Cost

**NEER:** Nominal Exchange Rate

**REER:** Real Exchange Rate

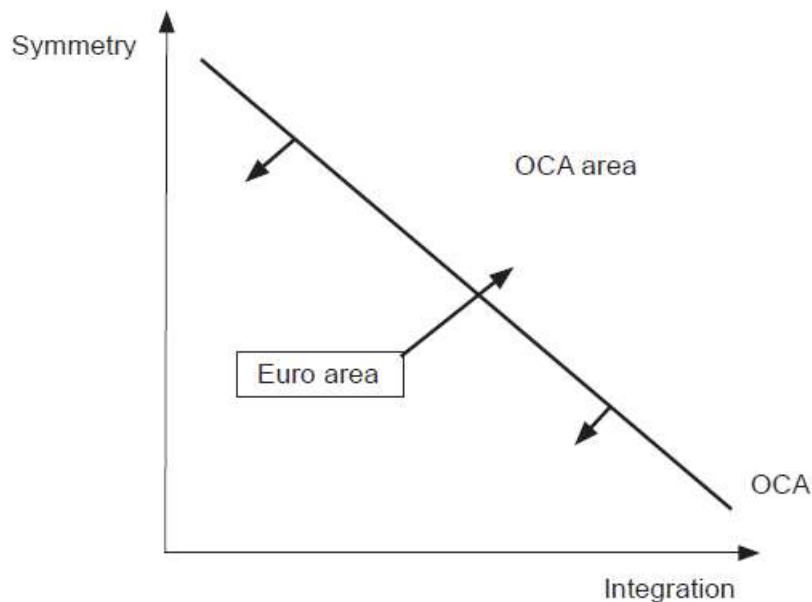
**HICP:** Harmonized Consumer Price Index



Source: European Commission

# The effect of monetary union on symmetry

Figure 5: Symmetry and Integration as OCA Criteria



Has been heavily debated among economists (see De Grauwe, 2005).

**No consensus seems to have emerged here**, although the empirical work of Frankel and Rose (1998) indicating that **trade integration and output correlation** go hand-in-hand has become **quite influential**.

On the whole the theory and the evidence seem to suggest that there is a **dynamics of endogeneity** that has the potential of moving the euro area countries towards the OCA area.

**How important this endogeneity** effect is, however, **cannot be determined** at this stage of our knowledge.

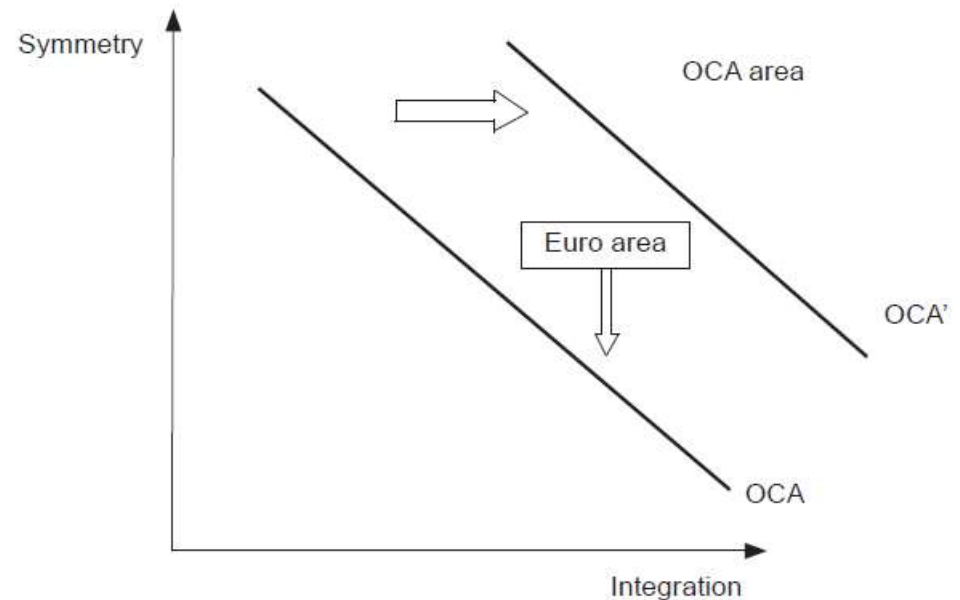
# III. The Governance of Monetary Union

There is a **fundamental difference between the monetary union among the US states and the European monetary union.**

The **US federal government** has a monopoly of the use of coercive power within the union and will **surely prevent any state from seceding from the monetary union.**

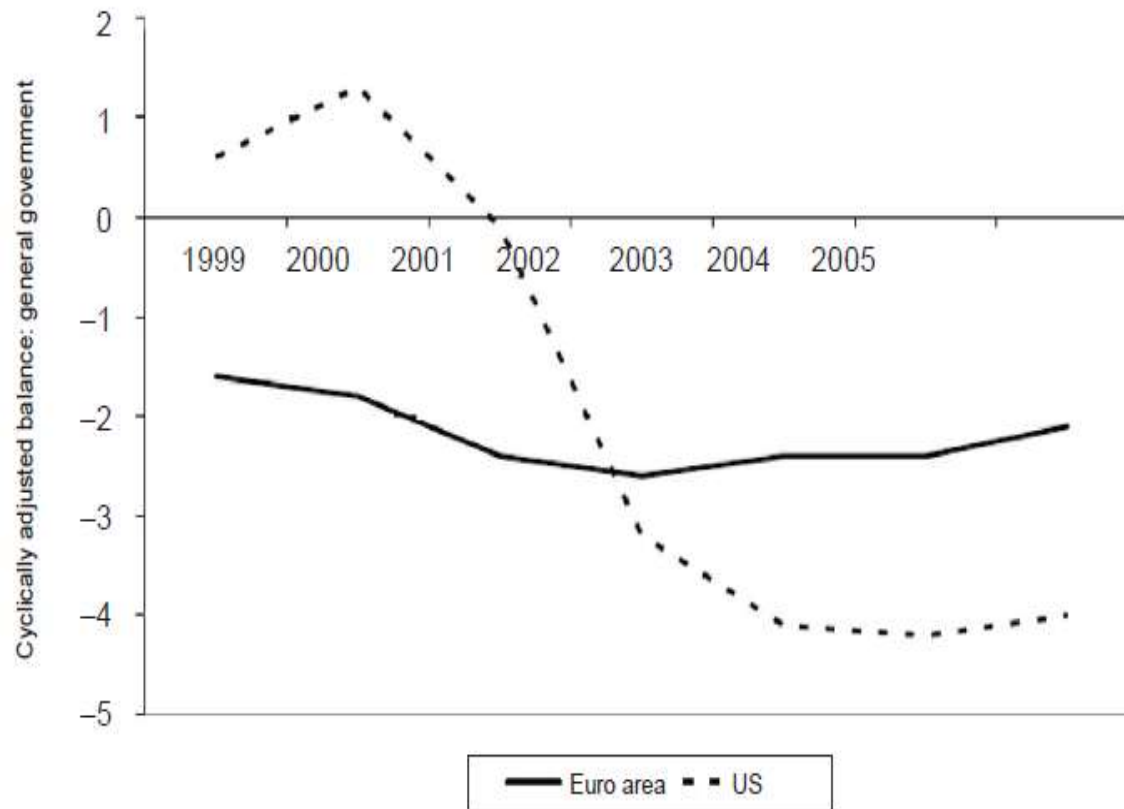
The contrast with the Member States of the euro area is a very strong one

Figure 6: Political Disintegration and the Optimality of the Euro Area



# Public Deficit in US versus EMU

Figure 7: Cyclically Adjusted Budget Balance in the Euro Area and the US



Source: Commission (2005).

# Panic driven austerity

- One question then remain, why was a such severe austerity plan implemented if from the early stage many economists did predict its negative GDP consequence and why did the BCE didn't take earlier measures?
- The financial market directly drove the intensity of each country's austerity program.
- Paul de Grauwe & Yuemei Ji, "Panic driven austerity in the eurozone and its implications", Social Europe, Columns&Interviews, (online), 25/02/2013, [http://www.socialeurope.eu/2013/02/panic-driven-austerity-in-the-eurozone-and-its-implications/?utm\\_source=feedburner&utm\\_medium=feed&utm\\_campaign=Feed%3A+social-europe%2FwmyH+%28Social+Europe+Journal%29](http://www.socialeurope.eu/2013/02/panic-driven-austerity-in-the-eurozone-and-its-implications/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+social-europe%2FwmyH+%28Social+Europe+Journal%29)

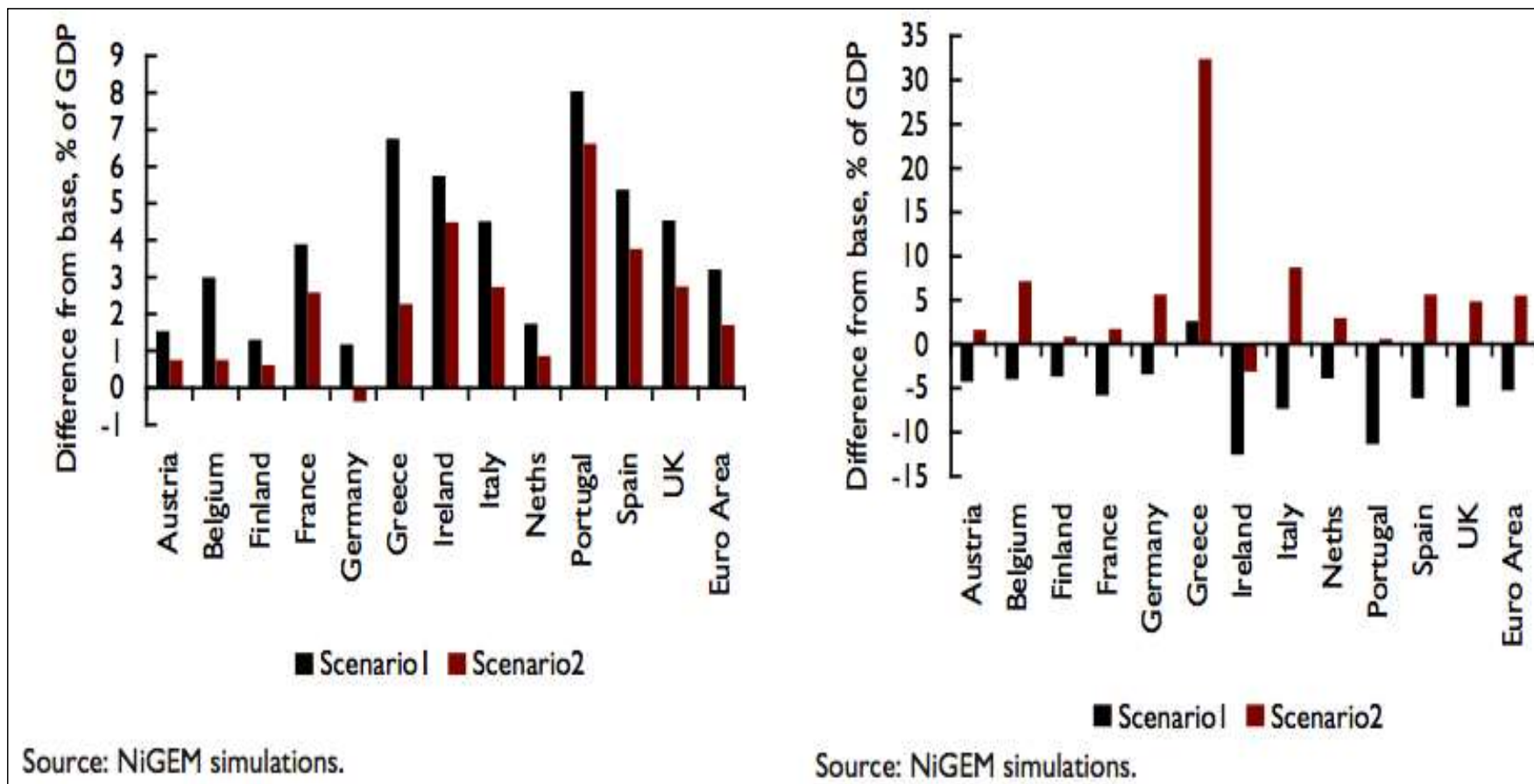
# Impact of austerity in GDP growth

- The **negative impact of the consolidation measures taken by the ECB on the GDP** was confirmed by Holland and Portes (2012).
- They implemented policy plans based on fiscal impulse (tax based and spending based) and considered two alternatives scenarios,
  - under the **first assumptions** the economy is behaving in **normal times** and under
  - the **second assumption** they allowed **liquidity constraints and an impaired interest rate channel** to reflect the **current** conditions.
    - The results were striking, see next graph with the simulations results on **the debt to GDP ratio**....



# Impact of fiscal consolidation

on fiscal balance 2013 and on government debt to GDP ratio 2013



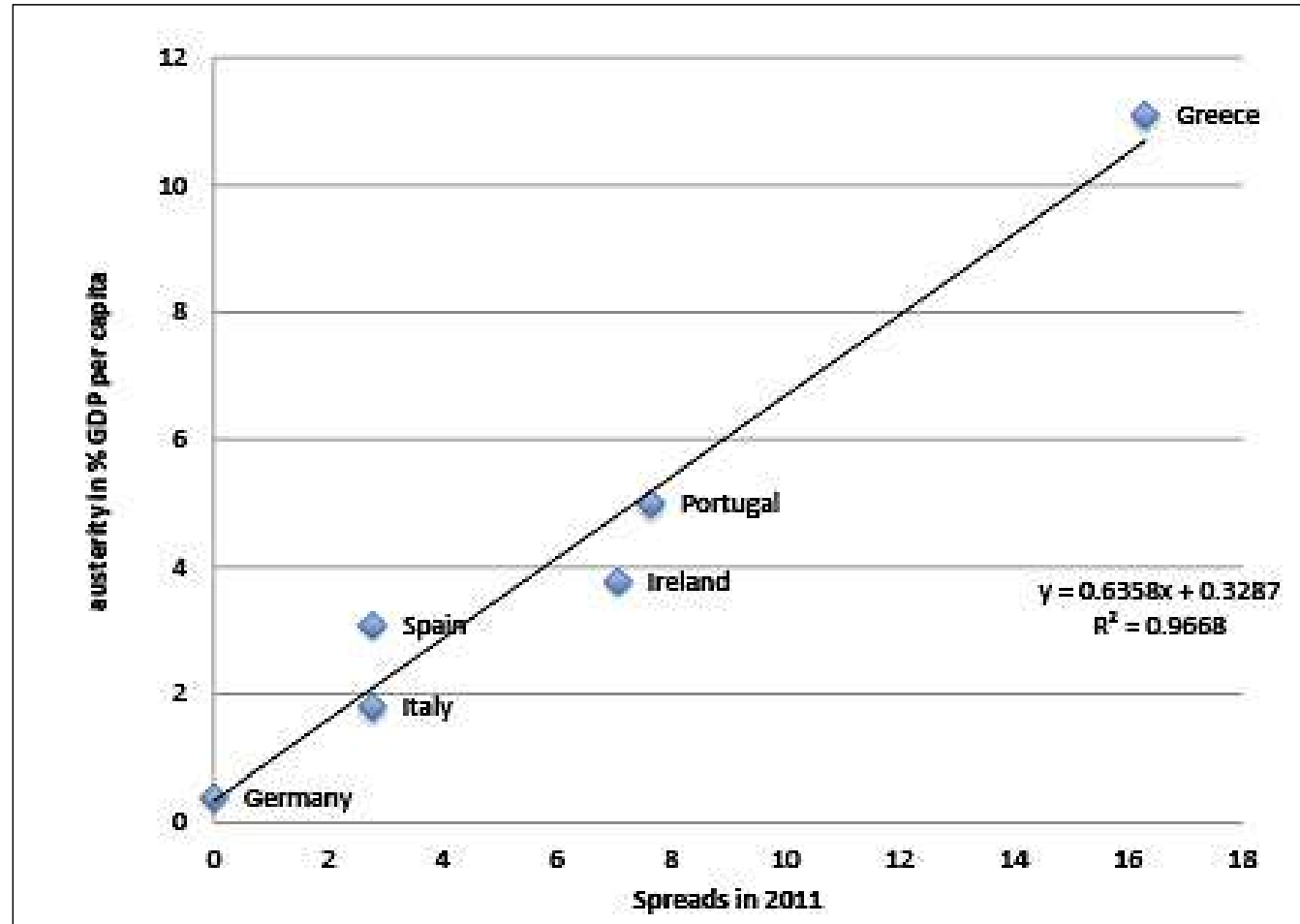
The results were striking, **fiscal consolidation** in Europe **has increased** rather than decreased **the debt to GDP ratio**, not only in countries with high debt and deficit but also in Germany and the U.K.

See: Holland D. & Portes J. 2012, "Self defeating austerity?", National Economic Institute Review, n°222 October.

# Austerity measure and spread 2011

(source: Financial Times)

Indeed according to the Financial Time **the higher the spread in 2011, the more intense were the austerity measures.**



# Eurozone policy seems driven by market sentiment.

- **De Grauwe** and **Jl**, (2013) argues that fear and panic led to **excessive**, and possibly self-defeating, austerity in the south while **failing to induce offsetting stimulus** in the north.
- The resulting **deflation bias** produced the **double-dip recession** and perhaps more dire consequences.
- As it becomes obvious that austerity produces **unnecessary suffering**, millions may seek liberation from 'euro shackles'.
- **Southern Eurozone** countries have been forced to introduce **severe austerity programs since 2011**.

# Where did the forces that led these countries into austerity come from?

**Are these forces the result of deteriorating economic fundamentals that made austerity inevitable?**

- Or could it be that the austerity dynamics were forced by **fear and panic** that erupted in the **financial markets** and then **gripped policymakers**.
- Furthermore, **what are the implications of these severe austerity programs for the countries involved?**

# What should we think of these two strongly opposing views?

Brussels–Frankfurt consensus/1

- The **Brussels–Frankfurt consensus** is based on two academic theories:
  1. **monetarist theory**
  2. **real business cycle theory**
- 1. The **monetarist theory**, in which
- the central bank **cannot do much to stabilize** the economy.
  - If it tries too hard to ‘fine-tune’ the economy it will end up with more inflation.
  - Thus the best thing a central bank can do is to **stabilize the price level. [inflation target]**
  - This will have the incidental effect of producing the best possible outcome in terms of **stability of the economic cycle. [but the main target is long term stability]**

# The real business cycle theory

Brussels–Frankfurt consensus/2

- the sources of economic cycles are:
  - shocks in technology (supply-side shocks) and
  - changes in preferences (unemployment being mainly the result of workers taking more leisure).
- There is very little the central bank can do about these movements.
- The best is to keep the **price level on a steady** course.
  - This will minimize the effects of these shocks.
- In addition, a macroeconomic policy based on the **objective of price stability is the best thing** the central bank can do **to promote growth**.

# The real business cycle theory

Brussels–Frankfurt consensus/3

- **Lucas:** the central bank's contribution to economic **growth** by maintaining **price stability** is immensely more important than an ephemeral success in reducing business cycle movements.
- That was the background to solve the crisis in 2010:
  - **BCE** cares about price stability and
    - in so doing makes the best possible contribution to maintaining
      - **macroeconomic stability** and
      - to **fostering economic growth**; and
  - **national governments** that
    - **keep budgetary discipline** and
    - do their utmost to introduce **market flexibility**.

# The real business cycle theory

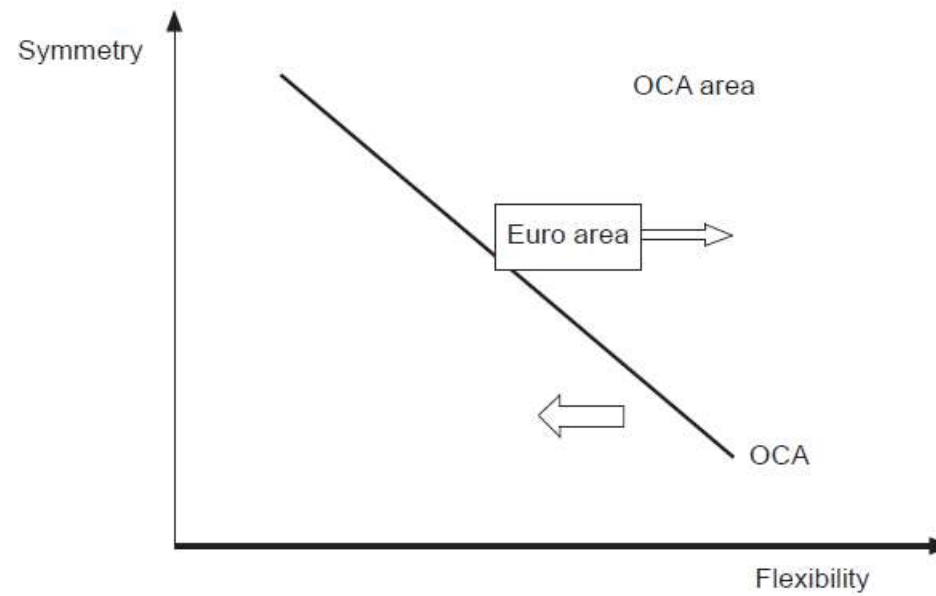
Brussels–Frankfurt consensus/4

- In such a world the productivity driven shocks can best be dealt with by governments **keeping budgets in balance.**
- Furthermore, in such a world the need to have an active budgetary policy at the euro area level does not exist.
  - It will also come as no surprise to those who have studied economic history that these were also the **views that prevailed prior to the Great Depression.**



# The Brussels-Frankfurt Consensus

Figure 8: The Brussels-Frankfurt Consensus



# The alternative OCA/1

Deeply rooted in Keynesian and neo-Keynesian ideas:

- **shocks** in the economy that do not originate in the supply side but find their origin in the **demand side**.
  - **'Animal spirits'**, i.e. waves of **optimism** and **pessimism** capture consumers and investors.
  - **These waves have a strong element of self-fulfilling prophecy**.
    - When pessimism prevails, consumers and investors alike hold back their spending, thereby reducing output and income, and
      - > validating their pessimism.
    - when optimism prevails, consumers and investors will spend a lot, thereby increasing output and income, and
      - > validating their optimism.

# The savings paradox.

## The alternative OCA/2

- The corollary of this effect is the well-known savings paradox.
- When **pessimism prevails** and consumers attempt to **save more**,
  - the ensuing **decline in income** will prevent them from increasing their savings ex post.
    - These phenomena were analyzed by Keynes long ago, but have been thrown in the dustbins of economic history.
    - Yet these ideas remain powerful, and have important influences on the governance of the monetary union.
- In the logic of these Keynesian ideas, a monetary union needs a **central budgetary authority**
  - capable of offsetting the desire of consumers **gripped by pessimism** to increase their savings, by **dissaving of the central government**.

# The logic of these Keynesian ideas

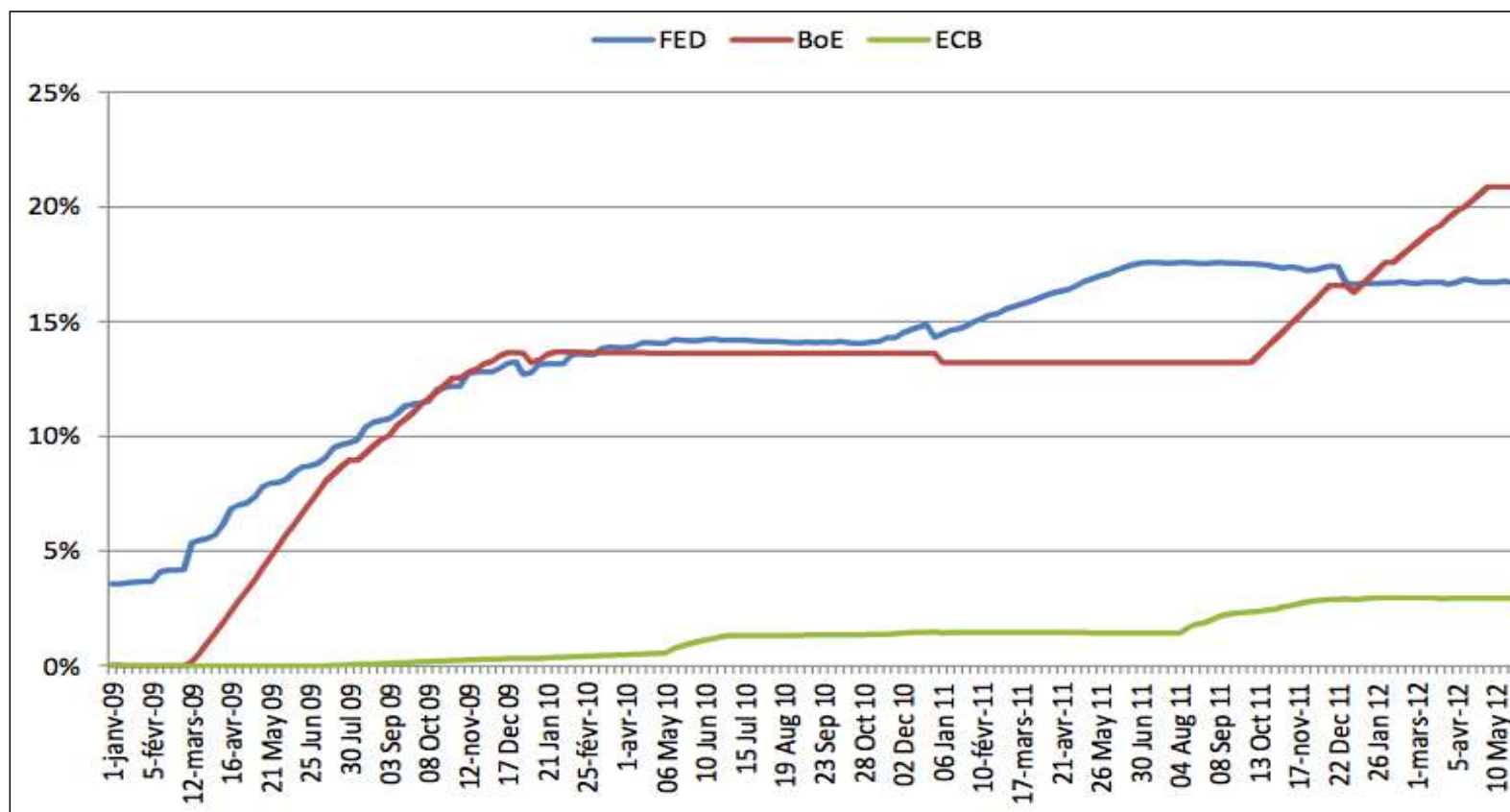
## The alternative OCA/2

- To the extent that there are asymmetric developments in demand at the national level,
  - the existence of an **automatic redistributive mechanism** through a centralized budget can be a powerful **stabilizing force**
- **The responsibility of a central bank extends beyond price stability**
  - even if this remains its primary objective of ECB.
  - There are movements in demand that cannot be stabilized by only caring about price stability.
    - **Quantitative easy**

# The monetarist-real-business-cycle (MRBC) theory policy implications

- From the preceding analysis it appears that the present governance of the euro area has been devised based on the assumption that the world is one which fits the monetarist-real-business-cycle (MRBC) theory.
  - If the latter theory is indeed the correct view of the world, there is little need to move on with political integration in the euro area, and the present political governance of the euro area is perfectly adapted to the world in which we live.
- **But what if the MRBC theory is not a correct representation of the world?**
- **What if there are large movements in optimism and pessimism that affect consumers' and investors' behavior?**
- If we live in a world where such large movements are possible, then the **euro area may have the wrong institutional design.**

# Central banks' securities purchase as % of GDP



**Source:** Daniel Gros, Cinzia Alcidi and Alessandro Giovanni, «Central banks in times of crisis : the FED vs the ECB », Economic policy, CEPS Policy Brief, (online), n°276 11 July 2012, <http://www.ceps.eu/book/central-banks-times-crisis-fed-vs-ecb>

# Conclusions

## What have we learnt about monetary unions since the Treaty of Maastricht?

- A first idea which may have helped to convince the critics of monetary union is that,
  - even if the euro area countries do not yet satisfy the OCA criteria, they will in the future
    - as the monetary union sets in motion a process of more intense integration.
    - This good-news-theory suggests that the euro area may be moving safely into the OCA area by the very fact that the euro area was started.
- The central idea here is that **the absence of a political union is an important flaw in the governance** of the euro area.

# Conclusions: ECB versus FED

- Council of the EU is putting all the burden of macroeconomic management in the euro area on the shoulders of the ECB [2001; 2010]
  - The ECB alone cannot fulfill this role.
- This contrasts very much with the US where we have seen that both
  - the central bank and
  - the federal government have used their respective instruments to stabilize the business cycle.



# Conclusions

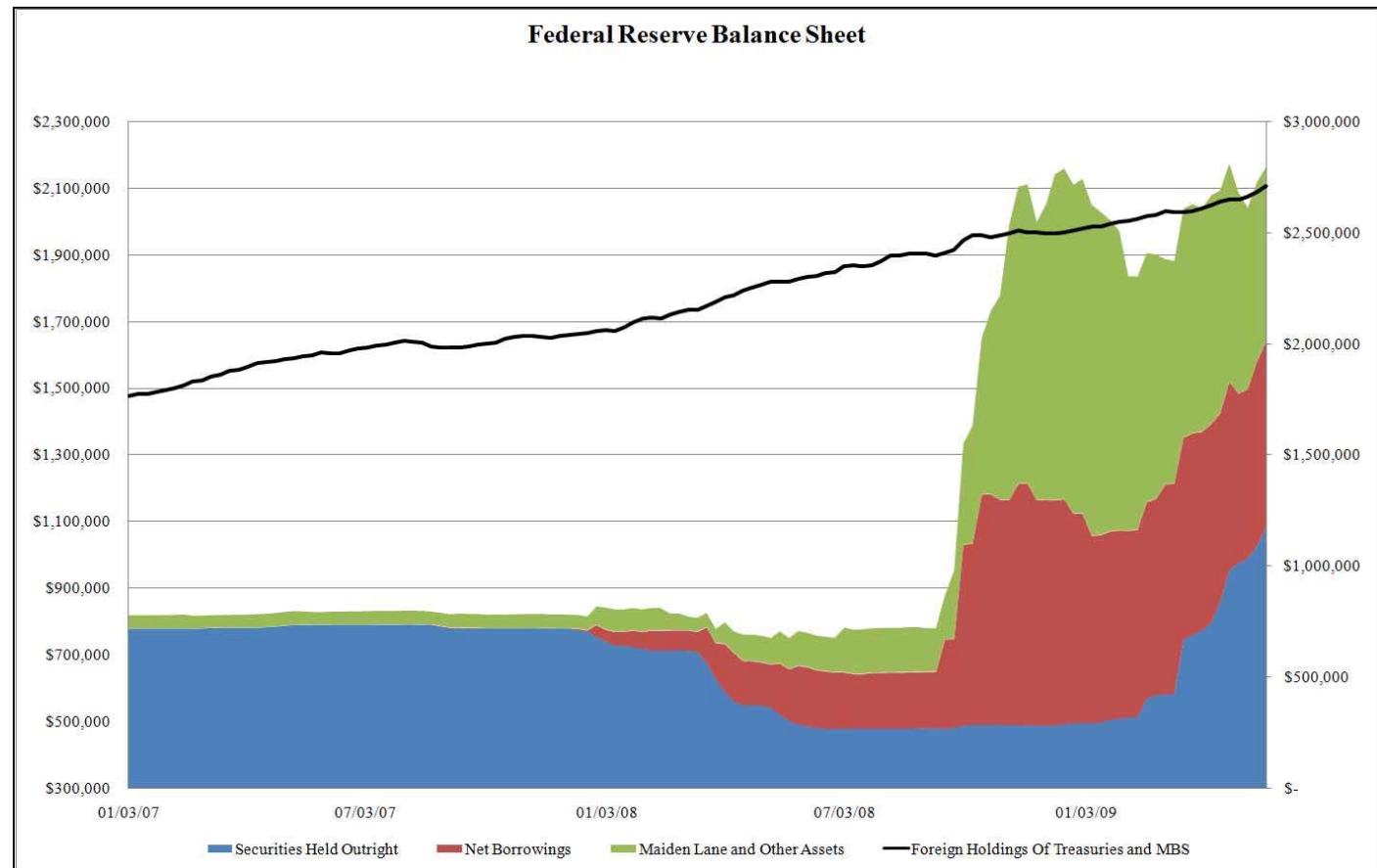
## The EU needs a budgetary integration

- The **absence of a minimal degree of budgetary integration** that can form the basis of an insurance mechanism **is another flaw in the design** of European monetary union.
- Such an insurance mechanism does **not have to be as large and unconditional as** those that exist within centralized countries.
- It is **important**, however, **as a mechanism of solidarity** even if its size is limited.
- It is difficult to conceive how a union can be politically sustainable if each time a country of the union gets into **trouble because of asymmetric developments**,
- it **is told by the other members that it is entirely its own fault** and that it should not count on any help.
- **Such a union will not last** (De Grauwe, 2006)

# Conclusions

## Quantitative easy

- Ben Bernake: 2008 plan to buy \$5000 mill. Trash assets base on morgates.
- -2009: \$300 mill. Acquisitions of long term bonds



# Conclusions: The BCE unconventional monetary policy: later an smaller

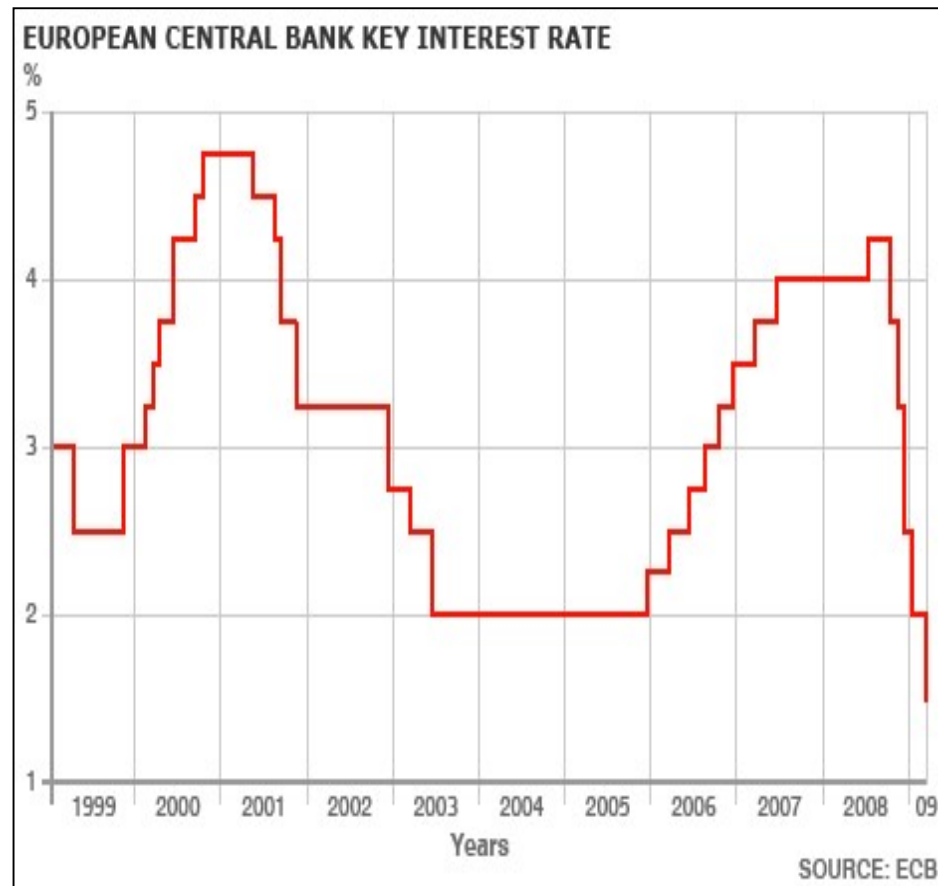
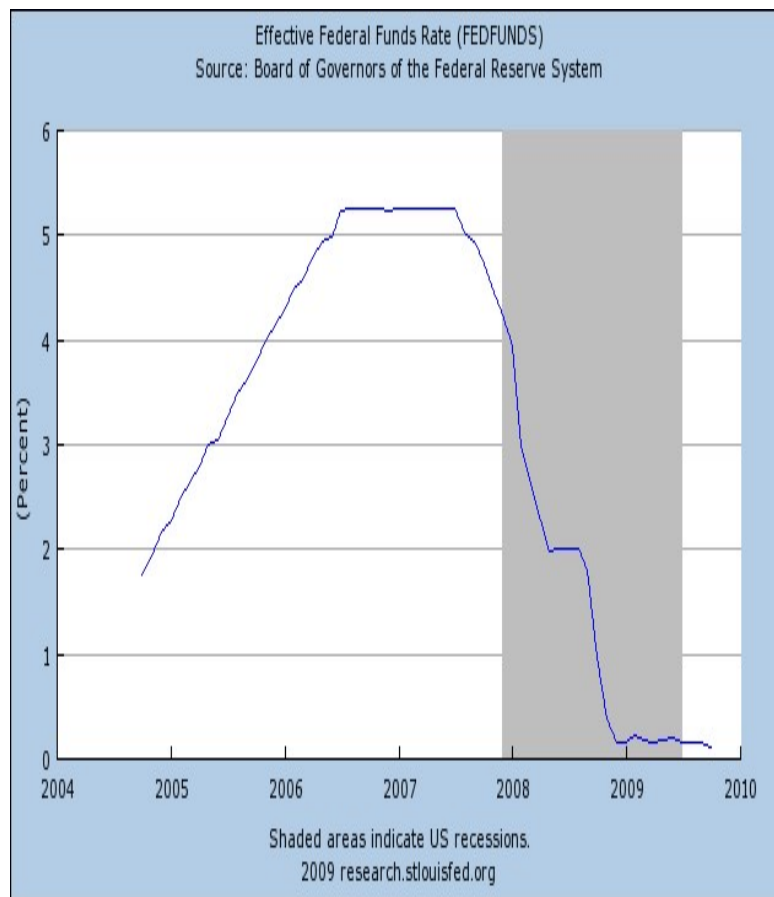
According to Gagnon et al. (2011), the **FED large-scale asset purchases of 2010 lead to a reduction of the ten-year term premium** between 30 and 100 basis points.

Moreover by **improving market liquidity and removing asset** with high prepayment risk from private portfolio, the FED had an even **stronger effect on the long-term interest rates on agency debt** and agency back mortgage securities. **The FED has therefore succeeded in stimulating the economic activity.**

**Unfortunately the ECB policy was not as successful;**



# Conclusions: FED Interest rate fast reduction since the BCE is lagging behind



# Conclusions: Positive effects in the spread of corporations after the 2008 crisis in the US

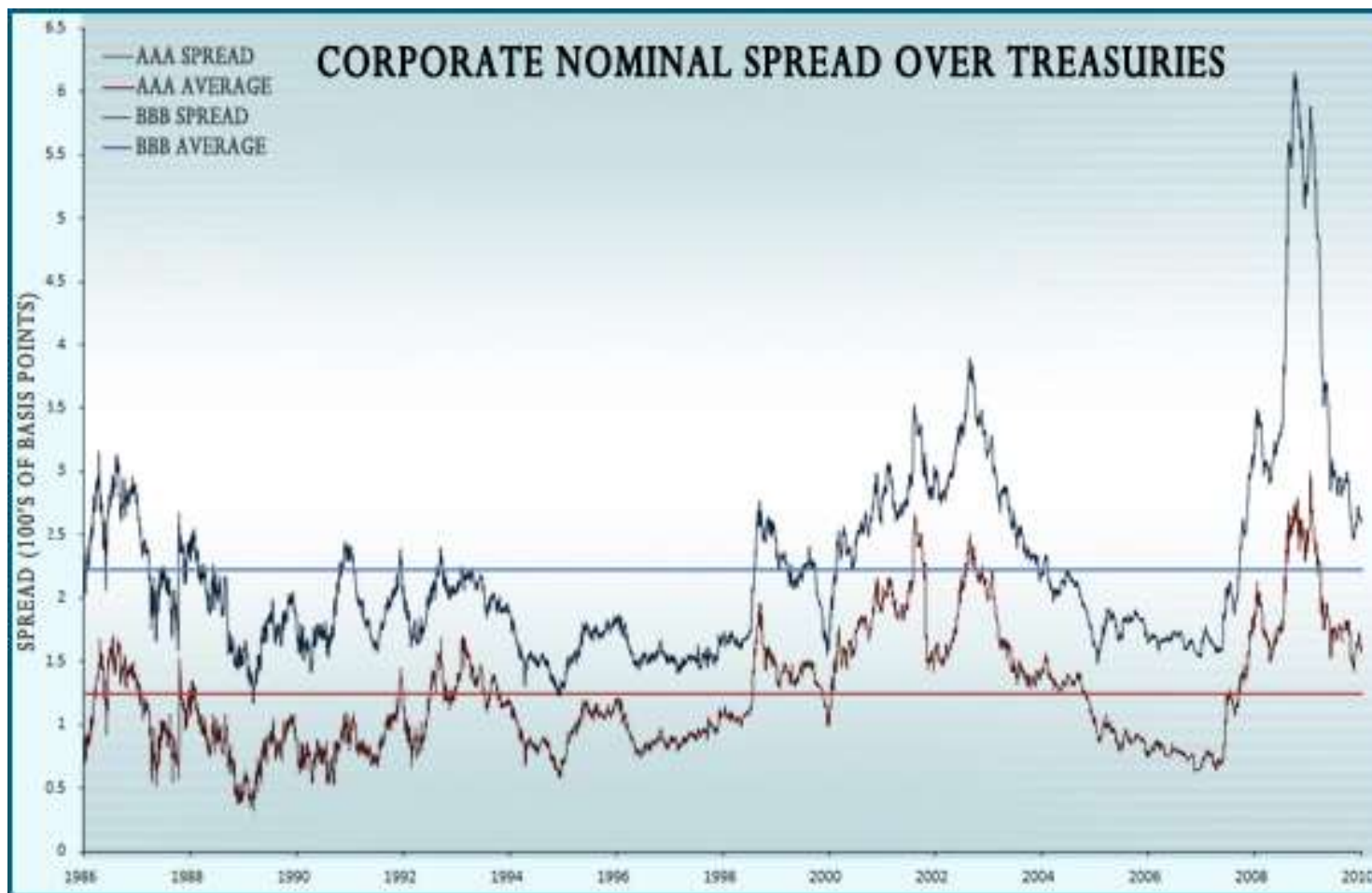
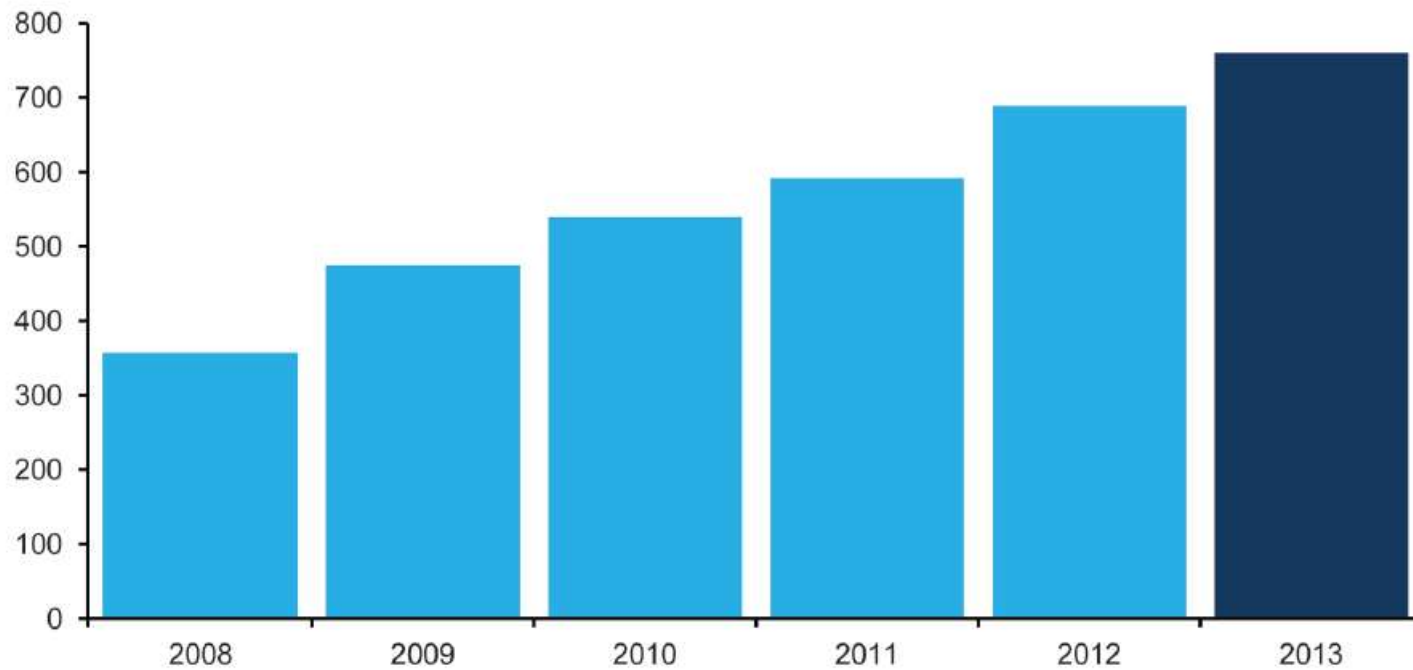


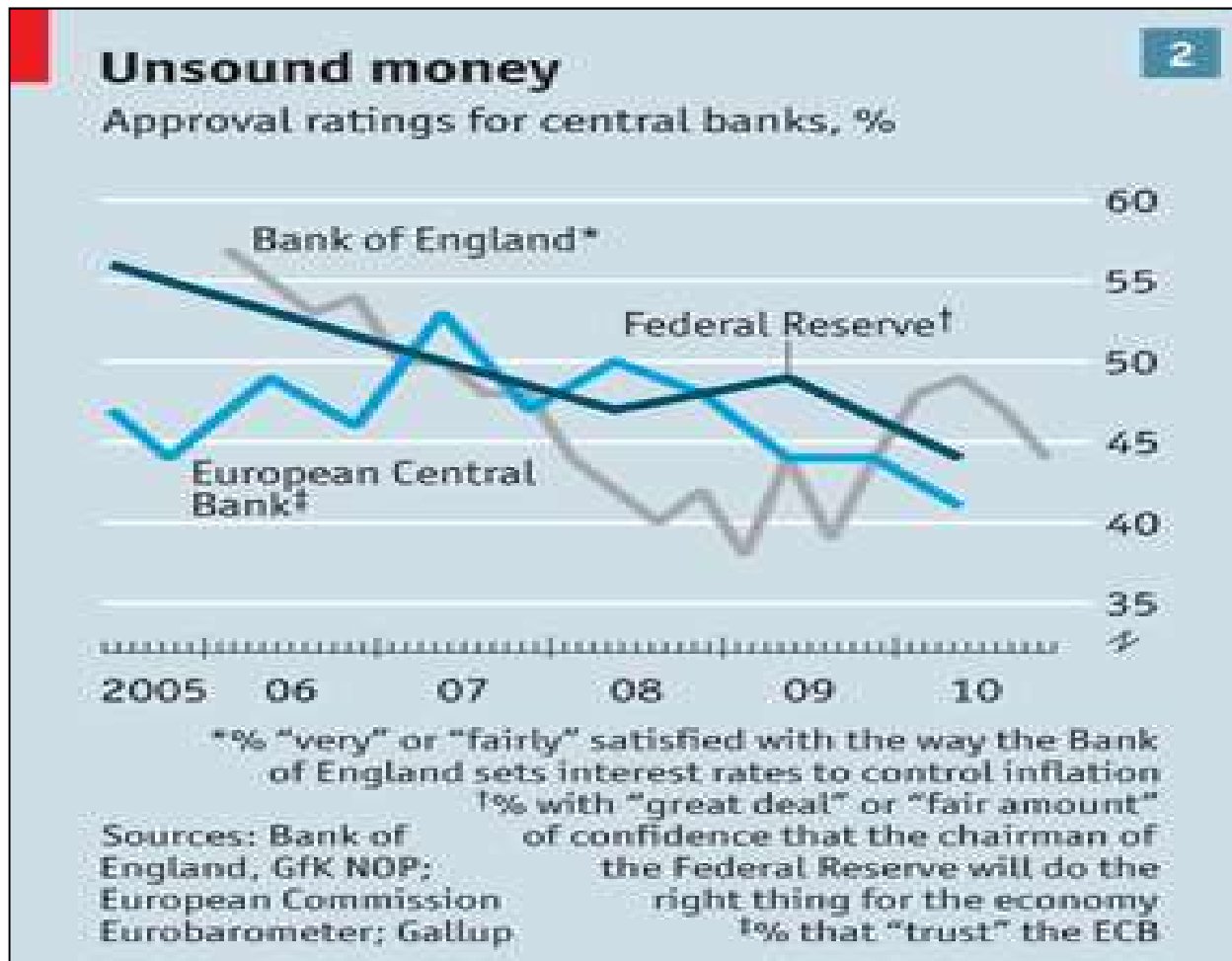
Exhibit 4

**Spanish central government outstanding debt (billions of euros)**



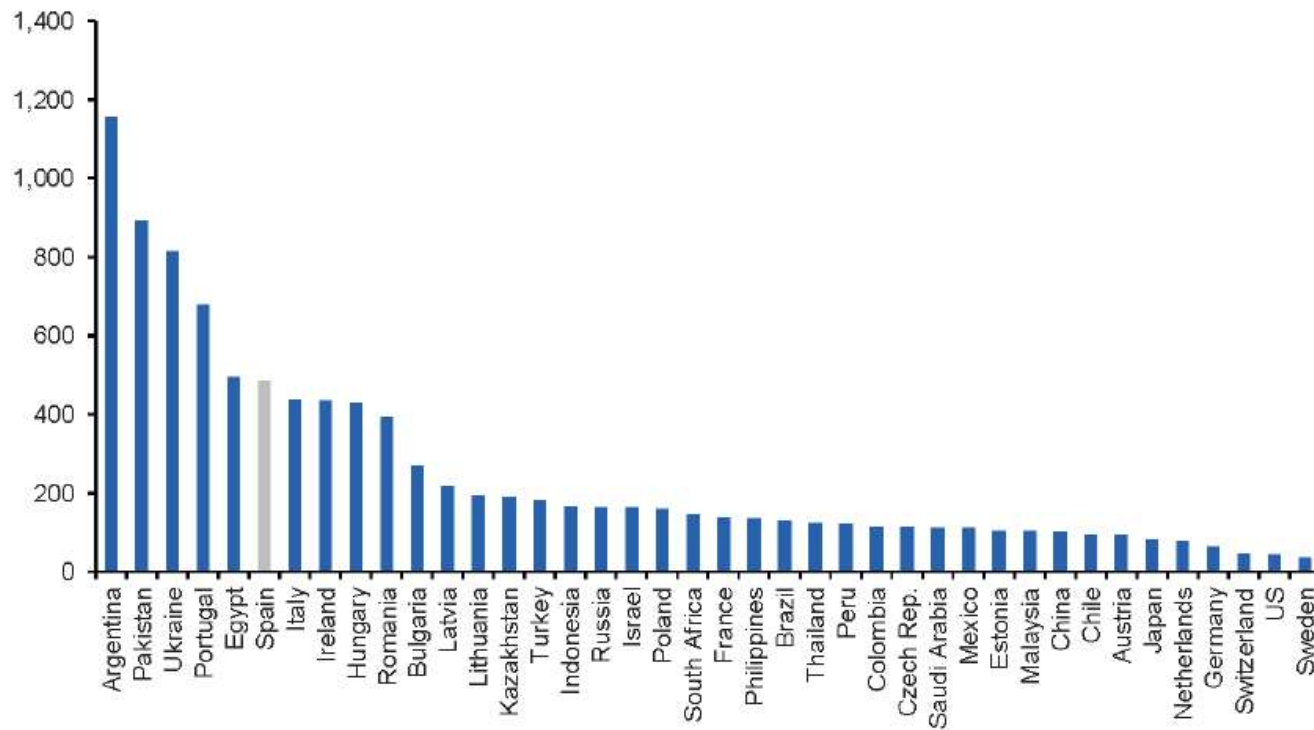
*Sources: Afi, Spanish Treasury.*

# Exercises: explain the following graphs



# Credit Default Swaps (CDS) Spread 2012

Exhibit 9  
Sovereign CDS spread



Source: Factset.



Public opinions and elections in UK

Exercise: See the videos in CEP  
Elections economics in the UK and  
critically comment

# CEP Elections economics in the UK

- Austerity & Productivity in UK elections videos:

- 1. Austerity | John Van Reenen
- <https://www.youtube.com/watch?v=ifv51GKGxmM&index=2&list=PLyYjq-iDxl32KwFj-BqAqXHHb0LXG9MhZ>
- 2. Productivity & Business | Anna Valero:
- <https://www.youtube.com/watch?v=Rn25PjLynDk&list=PLyYjq-iDxl32KwFj-BqAqXHHb0LXG9MhZ&index=7>
- 3. Britain & Europe | Thomas Sampson:
- [https://www.youtube.com/watch?v=BFQ\\_gJRcOfw&index=8&list=PLyYjq-iDxl32KwFj-BqAqXHHb0LXG9MhZ](https://www.youtube.com/watch?v=BFQ_gJRcOfw&index=8&list=PLyYjq-iDxl32KwFj-BqAqXHHb0LXG9MhZ)

# Public opinion

