WILL THE €uro SURVIVE?

Iain Begg
European Institute, London School of Economics
YES

But please don’t leave yet...
Key Features of Euro Area Economic Governance

- Primary imperative for ECB: price stability
- Fiscal policy remains with the Member State
  - As does supply-side policy
- Caught in trap of 16/27 membership
  - Hence confusion in responsibilities of different actors
- Necessitates extensive resort to coordination

>> The EU is **not** a United States of Europe, but more a united Europe of states
THE INSTITUTIONAL MIX

ECB

ECOFIN & EUROGROUP
THE INSTITUTIONAL MIX

COMMITTEES:
Economic policy
Employment
Social protection

ECONOMIC AND FINANCIAL COMMITTEE

MACROECONOMIC DIALOGUE

ECB

ECOFIN & EUROGROUP

MEMBER STATES

COMMISSION

ECOSOC & OTHERS

NATIONAL CBs
PRINCIPAL SHORTCOMINGS

- ECB as sole, EU level economic actor
- Aggregation of national policies: policy mix
  - Certainly fiscal, but also supply-side
- Wrong focus of surveillance
  - Especially, neglect of imbalances and their causes
- No explicit crisis resolution mechanism
  - Tricky wording of ‘no bail-out’ clause in Treaty
- Political economy of implementation
  - The ‘why comply?’ Catch-22s – legitimacy
LONG-TERM INTEREST RATES SINCE START OF FINANCIAL ‘CRISIS’

Interest rate, %

Aug-07 Oct-07 Dec-07 Feb-08 Apr-08 Jun-08 Aug-08 Oct-08 Dec-08 Feb-09 Apr-09 Jun-09 Aug-09 Oct-09 Dec-09 Feb-10 Apr-10 Jun-10 Aug-10

Germany Ireland Greece Spain France Italy Portugal
GROWING DIVERGENCE IN CURRENT ACCOUNT OF BoP

% of GDP


Germany  Netherlands  Greece  Spain  France  Italy  Portugal  Ireland
TRENDS IN CONSUMER PRICES OF EURO AREA COUNTRIES, 1999-2010

Change in price level over period, %

- Euro area 16
- Germany
- Finland
- France
- Austria
- Belgium
- Netherlands
- Italy
- Malta
- Portugal
- Ireland
- Cyprus
- Luxembourg
- Spain
- Greece
- Slovenia
- Slovakia

Legend:
- 1999-2003
- 2003-2007
- 2007-2010
### EXTENT OF ULC SHIFTS ....pre-crisis!

<table>
<thead>
<tr>
<th>Member State</th>
<th>Change 2000-08, %</th>
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<tbody>
<tr>
<td>Spain</td>
<td>29.3</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Greece</td>
<td>25.0</td>
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<td>Portugal</td>
<td>21.8</td>
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<tr>
<td>Belgium</td>
<td>17.2</td>
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<tr>
<td>France</td>
<td>17.1</td>
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<tr>
<td>Germany</td>
<td>-0.2</td>
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<td><strong>Euro area</strong></td>
<td><strong>14.8</strong></td>
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<tr>
<td>UK</td>
<td>22.8</td>
</tr>
<tr>
<td>Poland</td>
<td>6.8</td>
</tr>
</tbody>
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“THINGS THAT CAN’T GO ON FOREVER… DON’T”

Herb Stein [Nixon’s economic adviser]
.....THEN CAME MAY 2010

AND NOVEMBER 2010...AND?

Greece
Ireland
DISTINCT ‘PATHOLOGIES’

PUBLIC SECTOR
- Weak & profligate
- Too costly

Greece
Portugal?

BANKING CRISIS
- Systemic risk
- Bail-out

Ireland
Spain next?

SOVEREIGN DEBT CRISIS

COMPETITIVENESS
- Unit labour costs

Greece
Portugal
Spain
STRUCTURE OF DEBT, EXCLUDING FINANCIAL SECTOR

% of GDP, 2009

Source: Laurence Boone, Barclays Capital
EXPLAINING RECENT PROBLEMS

Germany’s changed role in Europe
- Traditionally the ‘good European’
- But new generation of leaders and new times
- Awkward domestic constraints
  - The constitutional court – most trusted institution
  - Public opinion, articulated by Bild Zeitung

Unintended consequences of Deauville
- Correct for long-term
- But threw petrol on the flames
  - Burning Ireland and igniting Portugal
EMERGING SOLUTIONS: OUTCOME OF van ROMPUY TASK FORCE

- Better macroeconomic surveillance
  - Macroeconomic, with focus on risky imbalances
    - Internal, but with ramifications for external
  - Structural indicators
- Fiscal frameworks and/or rules at national level
- Changes in the Stability and Growth Pact
  - Debt indicator to complement 3% deficit limit
- A new sanctions regime
- Preferably, to be achieved within existing Treaty
THE MEANS
Dark arts of rules & persuasion

- Better prevention along with coordination
  - The two semester approach
- New excessive imbalances procedure ‘EIP’
  - A scorecard with ‘alert’ indicators
  - But leavened by judgement
  - In-depth reviews: is action needed?
    - If the latter, recommendations will be issued
- Sanctions for euro area members
  - Only euro area members vote
- National rules consistent with SGP
UNFINISHED...OR TOO HARD

- Crisis resolution mechanism
  - Unease about involvement of IMF
  - Need for mini-Treaty change
    - Avoiding case before German Constitutional Court
  - Concerns about moral hazard

- Nature and scope of possible EMF

- Euro-bonds as a means of pooling risk
  - Moral hazard concerns again; adverse incentives

- The spectre of ‘fiscal’ union
  - If only we knew what it meant
CONCLUDING REMARKS

- Many political economy issues
  - Subsidiarity: who controls?
  - Winners and losers: who is really being rescued?
- Germany is pivotal
  - Usually does the right thing … eventually
- Progress towards financial stability
  - Yet there is, effectively, no ‘European tax-payer’
- New realism about costs of non-compliance
  - Doubts nevertheless persist about delivery

>> Political will, that elusive ingredient
SO, IS THE EURO IN PERIL?

My answer:
It remains part of the solution,
but is at a tricky crossroads